February 13, 2012

Secretary Timothy Geithner
Department of the Treasury
Docket No. OCC-2011-0014
RIN: 1557-AD44

Acting Comptroller John Walsh
Office of the Comptroller of the Currency
RIN: 1557-Ad44

Chairman Benjamin Bernanke
Board of Governors of the Federal Reserve System
Docket No. R-1432
RIN: 7100 AD 82

Acting Chairman Martin Gruenberg
Federal Deposit Insurance Corporation
RIN: 3064-AD85

Chair Mary Schapiro
Securities and Exchange Commission
RIN: 3235-Al07

All, care of: Via Email
Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds

Dear Secretary, Chairs, Acting Chair, and Acting Comptroller,

On behalf of more than 250,000 Public Citizen members and supporters, we are pleased to comment on the Proposed Rule regarding implementation of § 619 of the Dodd-Frank Wall Street Reform Act, commonly known as the Volcker Rule. Our letter responds to the joint request for comment by the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the Department of the Treasury, and the Securities and Exchange Commission ("the Agencies").

The genesis of the current Volcker Rule proposal dates to a January 2009 Group of 30 report undertaken in response to the global financial crisis of 2008.[1] First among the Group's 18 recommendations was a ban on taxpayer-sponsored institutions' traffic in proprietary, high risk activities with little connection to traditional customer services. The Group explained:

> Recent experience in the United States and elsewhere has demonstrated instances in which unanticipated and unsustainably large losses in proprietary trading, heavy exposure to structured credit products and credit default swaps, and sponsorship of hedge funds have placed at risk the viability of the entire enterprise....These activities, and the "originate-to-distribute" model, which facilitated selling and reselling highly engineered packages of consolidated loans, are for the most part of relatively recent origin. In essence, these activities all step away from the general concept of relationship banking, resting on individual customer service, toward a more impersonal capital markets transaction-oriented financial system. What is at issue is the extent to which these approaches can sensibly be combined in a single institution, and particularly in those highly protected banking institutions at the core of the financial system.

After President Obama endorsed the proposal, coining the term "Volcker Rule," Congress approved the reform as part of the Dodd-Frank Wall Street Reform Act legislation. Before final approval, a July 15, 2010 colloquy between Senators Merkley and Levin, the drafters of Section 619, established the intention of the statute itself.[2] Senator Merkley explained the ambition of the statute as embracing "the spirit of the Glass-Steagall Act's separation of 'commercial' from 'investment' banking by restoring a protective infrastructure around our critical financial infrastructure....While the intent of Section 619 is to restore the purpose of the Glass-Steagall barrier between commercial and investment banks, we also update that barrier to reflect the modern financial world."

This modernization necessarily involves the need to address complexity, and the Agencies have appropriately delegated considerable attention to the many realities of the modern financial marketplace.

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[1] "Financial Reform, a Framework for Financial Stability, Group of Thirty, available at:www.group30.org/images/PDF/Financial_Reform-A_Framework_for_Financial_Stability.pdf

[2] Colloquy of Senators Levin and Merkley, July 15, 2010, Congressional Record, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

Our comment follows subject areas central to successful enforcement, from the proposed guardrails that distinguish permitted market making from prohibited proprietary trading, to repurchase agreements, securitizations, hedge funds, capital requirements and other areas.

Sincerely,

David Arkush,
Director, Public Citizen's Congress Watch

Bartlett Naylor
Financial Policy Advocate, Public Citizen's Congress Watch

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Market making

Traffic in complex financial instruments developed by the banking industry contributed to the financial crisis of 2008. The trading book contained the basic elements of the crisis. Metrics reliant on short-term data applied to the trading book concealed tail risk. Low capital requirements in the trading book invited capital arbitrage, making this account the dumping ground for problem assets. High leverage allowed in this account rendered the markets especially fragile.

Senators Levin and Merkley identified proprietary trading losses of $230 billion in the years associated with the financial crash culminating in the fall of 2008. Eventually, the taxpayer bailout equated to clearly identifiable figures for specific firms. [3]

Section 619 focusses on the nature of the trading book, then mandates clear activity restrictions and safeguards against capital arbitrage, and provides for increased capital, and other quantitative limits.

The statute provides in section 13(1) that "a banking entity shall not ... engage in proprietary trading." Such activity can lead to extreme losses, and led to taxpayer bailouts during the financial crisis.

Section 13(h)(4) effectively defines "proprietary trading" broadly as any principal trading from the bank trading book, establishing a sweeping ban on securities activity in the bank trading book. Section 13(d)(1) then instructs regulators to allow a number of permitted activities within blanket prohibition, including market making, underwriting, and hedging. While enumerating these permissions, Section 13(d)(2) then specifies that no activity may be permitted where:
--they pose a threat to the safety or soundness of the bank
--they pose a threat the financial stability of the United States
--they create conflicts of interest with customers
--they expose the bank to high-risk assets or trading strategies.

We emphasize these statutory provisions as pivotal to the Agencies' posture in addressing parameters to distinguish permitted from prohibited activity.

The clearest opportunity for evasion of the prohibition on proprietary trading is through market-making. Consequently, the Agencies appropriately recognize the need for vigilance with the permission in the Volcker Rule for legitimate market making.

The Agencies describe legitimate market making in Appendix B. "The primary purpose of market making-related activities is to intermediate between buyers and sellers of similar positions, for which service market makers are compensated. . . . The purpose of such activities

[3] "The Dodd-Frank Restrictions on Proprietary Trading," by Sen. Jeff Merkley and Sen.Carl Levin, Harvard Law Journal, available at http://www.harvardjol.com/wp-content/uploads/2011/07/Merkley-Levin_Policy-Essay.pdf

is not to earn profits as a result of movements in the price of positions and risks acquired or retained; rather, a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains, or in the price of one or more material elements of those positions." While the market maker generally provides liquidity to the market, the agencies should consider a refinement, explained by physicist-turned-derivatives analyst Nicholas Dunbar who observed, "Liquidity is the ability to trade an instrument in large volumes without shifting the price."[4]

In Appendix B, the agencies distinguish the speculator, or proprietary trader.

> Unlike permitted market making related activities, the purpose of prohibited proprietary trading is to generate profits as a result of, or otherwise benefit from, changes in the price of positions and risks taken. Whereas a market maker attempts to eliminate some or all of the price risks inherent in its retained principal positions and risks by hedging or otherwise managing those risks in a reasonable period of time after positions are acquired or risks arise, a proprietary trader seeks to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains. A proprietary trader does not have 'customers' because a proprietary trader simply seeks to obtain the best price and execution in purchasing or selling its proprietary positions. A proprietary trader generates few if any fees, commissions, or spreads from its trading activities because it is not providing an intermediation service to any customer or other third party. Instead, a proprietary trader is likely to pay fees, commissions, or spreads to other market makers when obtaining their liquidity services is beneficial to execution of its trading strategy. Because a proprietary trader seeks to generate profits from changes in the price of positions taken, a proprietary trader typically provides compensation incentives to its personnel that primarily reward successful proprietary risk taking.[5]

Despite the proposal's success in identifying the key characteristics of proprietary trading and market making in the abstract, the proposal falls short with numerical boundaries. The proposal eschews bright-line rules in favor of a set of factors for consideration. The factors generally are appropriate. However, the Agencies will face a daunting burden attempting to apply them post hoc to the millions of trades conducted weekly by actors who may be motivated to obfuscate the true nature of their activities. Moreover, the Agencies delineate no clear penalty for violations. Ultimately, a successful rule to ban proprietary trading should:

- Employ clear, bright-lines.
- Turn on objective facts, not the intentions of regulated entities.
- Employ strong, clear penalties for violations.

New York University Stern School professor and former Goldman Sachs employee Roy Smith advises "simplicity" and "bright lines." Such bright lines should include metrics independent of

[4] http://www.nickdunbar.net/?page_id=155
[5] Federal Register, at 68961.

the decision of a referee using judgment. Such metrics should be automatic and applied daily, as opposed to a longer period that may be prone to discussion or negotiation with regulators.6

Bright lines may exclude legitimate market making but this small opportunity cost must be viewed as the price of prudential reorientation to core banking activities.

What follows is a method the Agencies could deploy to implement the proprietary trading ban using a few very simple bright line rules. Subsequent are comments that hew more closely to the Agencies' proposed factors for distinguishing proprietary trading from market making.

A Parsimonious Solution

The proposed rule seeks to provide the Agencies the means to distinguish prohibited proprietary trading from permissible activities such as market making and hedging, after the trades have taken place. Under the proposal, the Agencies will weigh numerous factors and metrics, each of which can provide important evidence, but none of which is conclusive. This arrangement will provide banks with numerous opportunities for evasion and obfuscation while burdening the Agencies with difficult and resource-intensive detective work. In practice, these complications challenge successful implementation of the rule. We urge the Agencies to adopt an approach simpler than the one outlined in the proposal to implement the proprietary trading ban in § 619.

Section 619 bars banks from "proprietary trading" of securities but permits them to trade securities for a few other purposes. The Agencies' challenge is to distinguish between what is permissible and impermissible. This task is considered challenging because third parties cannot easily discern the purpose of a bank's trading activity. But a simple rule can resolve much of this problem: The Agencies should prohibit banks from profiting from movements in the prices of the securities they trade (or prohibit profiting by more than de minimis amounts). In other words, instead of attempting to discern whether particular trades were legal or not, the Agencies instead can simply prohibit profit that flows directly from trading. This principle is the core of § 619. The section defines "proprietary trading" in relevant part as "engaging as a principal for the trading account of the banking entity . . . to purchase or sell . . . any security"7 and defines "trading account" in relevant part as "any account used for acquiring or taking positions . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements) . . . ."8

For some of the permitted trading activities, such as market making, banks can earn money without profiting directly from trades. Banks engaged in market making—which must be based on customer demand9—can charge their customers fees or commissions for the service provided. These fees could be structured a number of ways. Banks could charge customers based on the number of securities at issue in a given trade, or a percentage of the value of each transaction, or could simple charge a flat monthly or annual fee. Banks also can profit from bid-ask spreads.

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[6] From, email correspondence
[7] 12 U.S.C. § 1851(h)(4).
[8] 12 U.S.C. § 1851(h)(6)
[9] 12 U.S.C. § 1851(d)(1)(B).

None of these sources of revenue requires profiting from movement in a security's price—what § 619 prohibits. A similar analysis applies to underwriting.[10]

For other permissible purchases and sales of securities, such as "risk-mitigating hedging,"[11] banks have incentives to engage in the trading without the need to profit from price movements. If banks choose to take positions in securities to mitigate risks, their reward is successful risk mitigation. They should be required to identify precisely what is being hedged with each securities transaction, and they should not be permitted to retain any gains from the transactions beyond amounts that counterbalance losses from the specific banking operations that were hedged.

Neither type of trading inherently involves profit from price movements—and neither is in conflict with § 619's ban on proprietary trading so long as it does not involve profit from price movements. The Agencies should require disgorgement from banks of any profits—or any profits beyond de minimis amounts—from price movements in securities traded. Any profits disgorged could be placed in an FDIC fund for the resolution of failing banks or, in the case of market-making, returned to customers.

A rule requiring disgorgement of trading profits would also help effectuate the conflict of interest ban in section 1851(d)(2)(A)(i). If banks are not permitted to profit from trades, then clients, customers, and counterparties can be assured that a bank with which they are engaging in business does not have at least one important type of conflict of interest with them.

The disgorgement rule also should bolster implementation of the prohibition on "material exposure . . . to high-risk assets or high-risk trading strategies."[12] If banks are not permitted to profit from trading in securities, then they have far less incentive to purchase high-risk assets or engage in high-risk trading strategies. Such assets and strategies would involve the possibility of severe harm to the bank without a countervailing likelihood of benefit.

The disgorgement rule approach offers important advantages over the Agencies' proposal. The proposal would burden Agency resources far more than a bright-line rule, requiring the Agencies to engage in extensive analytic detective work. More important, the Agencies' work, however diligent, would almost certainly fall short in many instances, allowing banks to evade the rule. The bright-line rule would be much more difficult to evade. It neatly reconciles the provisions in § 619 that are often thought to conflict with one another, such as the ban on proprietary trading and the exception for market making.

The Agencies' Criteria

Regarding the Agencies' effort to identify methods for distinguishing legitimate market making from prohibited proprietary trading, the Agencies ask [in Question 188]:"For which of the relevant quantitative measurements might it be appropriate and effective to include a numerical

[10] 12 U.S.C. § 1851(d)(1)(B).
[11] 12 U.S.C. § 1851(d)(1)(C)
[12] 12 U.S.C. § 1851(d)(2)(A)(ii).

threshold that would trigger banking entity review and explanation? How should a numerical threshold be formulated, and why? "

We appreciate the utility of these specific criteria and ask consideration for specific metrics. Given the confidential nature of trading data, impartial expert analysis of appropriate prudential boundaries are available only to regulators. As such, we propose that the Agencies adopt such criteria internally and apply them to regulatory reporting by trading desks (as provided in proposed measurement criteria of Appendix A). Establishment of such bright line criteria can be iterative/evolving based on regulatory experience. For example, the Agencies may establish a certain metric, then either tighten or relax them as evidence reveals the actual boundaries of what becomes understood as legitimate market making. These criteria should not be revealed to banking entities themselves on the grounds that they may engage in evasionary proprietary trading near the boundary. Agencies can then inspect the details of transactions where a banking entity breaches the Agency's boundary. This will lead either to modification of the boundary, or institution of penalties.

Most clearly, as stated above, market-makers must profit from fees or spread, not price changes. Market makers should not "outperform" the market.

Spread Profit and Loss is the portion of Portfolio Profit and Loss that generally includes revenue generated by a trading unit from charging higher prices to buyers than the trading unit pays to sellers of comparable instruments over the same period of time (i.e., charging a "spread," such as the bid-ask spread). "Source of revenues" must consist of a specific minimum percentage from spread. A benchmark of a period of legitimate market-making transactions in both a stable and volatile/unstable market should be established upon which only a de minimus percentage deviation in profit would be tolerated from price changes.

Similarly, the volatility of profit and loss can signal proprietary trading. Portfolio Profit and Loss to Volatility Ratio is a ratio of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, to the Volatility of Portfolio Profit and Loss, exclusive of Spread Profit and Loss, for a trading unit over a given calculation period. Chairman Volcker identified this parameter as central to the identification of speculation. "An analysis of volume relative to customer relationships and of the relative volatility of gains and losses would go a long way toward informing such judgments. For instance, patterns of exceptionally large gains and losses over a period of time in the "trading book" should raise an examiner's eyebrows. Persisting over time, the result should be not just raised eyebrows but substantially raised capital requirements."13 As a consequence, the Agencies should establish a clear line through iterative application of metrics.

Market making, as the Agencies rightly observe, must be characterized by continuous two-sided transactions. The market maker must both purchase and sell the same financial instrument. In their colloquy, Senators Levin and Merkley explained this. "Testimony by Goldman Sachs Chairman Lloyd Blankfein and other Goldman executives during a hearing before the Permanent Subcommittee on Investigations seemed to suggest that any time the firm created a new mortgage related security and began soliciting clients to buy it, the firm was "making a market"

[13] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4

for the security. But one-sided marketing or selling securities is not equivalent to providing a two-sided market for clients. The reality was that Goldman Sachs was creating new securities for sale to clients and building large speculative positions in high-risk instruments, including credit default swaps. Such speculative activities are the essence of proprietary trading and cannot be properly considered within the coverage of the terms "market making."14Market makers must demonstrate that the proportion of purchase and sale transactions be relatively equal and that any serious imbalance be grounds for penalty. If a firm constructs a product for sale to interested clients, the firm must demonstrate purchases of that same product equivalent to its sales.

The Agencies correctly designate arbitrage as prohibited proprietary trading as described in the preamble and in 3(b)(2)(i)(A)(3). Arbitrage lacks benefiting customers.

Regarding anticipated demand for a promising financial instrument, the Agencies note that the acquisition of positions must be "based on more than a simple expectation of future price appreciation and the resulting generic increase in marketplace demand. Rather, the expectation should generally be based on the unique customer base of the banking entity's specific market making business lines and the near-term demands of that customer base based on particular factors beyond a general expectation of price appreciation." As for implementation, we urge the Agencies to establish clear criteria that reflect appropriate revenue from changes in the bid-ask spread. The genuine market maker should be selling as well as acquiring positions in a rising market. The same should be true in the inverse where the market maker perceives deterioration in a certain financial instrument.

Accumulating positions in anticipation of demand opens issues of front running. The Agencies must be especially attuned to resulting revenues from these circumstances so that banking entities profit from announced spreads, and not increases in price owing to increased demand.

In a bona fide market making business, inventory positions should be viewed as a cost of doing business as opposed to a source for potential profit. The banking entity should therefore seek to minimize inventory; unusual inventory can signal proprietary positions. An Oliver Wyman study of showed that the volume of securities in inventory exceeded daily trading by roughly four times.15 Risk of loss and potential for gain must be measured. If either is larger than appropriate relative to the revenue of the purported market making business, this may indicate that the activity is not bona fide market making. Given the relative predictability of revenue in a bona fide market making business, a low level is appropriate, perhaps 2% (assuming a quarterly measurement). The un-hedged VaR of the inventory positions (including the VaR of the basis between the hedge and the underlying position) can be key. In addition, the realized loss and the realized gain on inventory positions (including the realized loss and the realized gain associated with basis differential between inventory positions and hedges) should be separately measured. Risk of loss should be measured as the sum of instantaneous VaR and the realized losses since

[14] Colloquy of Senators Levin and Merkley, July 15, 2010, Congressional Record, available at http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

[15] "The Volcker Rule: Implications for the U.S.Corporate bond market," by Oliver Wyman, commissioned by the Securities Industry and Financial Markets Association, Dec. 14, 2011. Available at: www.sifma.org/workarea/downloadasset.aspx?id=8589936887

the last measurement. Potential for gain should be measured as the sum of instantaneous VaR and the realized gain since the last measurement.

The Agencies observe that a legitimate market maker generally receives fees, whereas a proprietary trader pays fees (in order to establish a position on which to profit from price changes). Where a trader pays a fee, the trader must be prepared to document the chain of custody to show that the financial product is shortly re-sold to an interested customer. A market maker who pays a fee to acquire a position must simultaneously hold a pending customer order to purchase that position. The revenue to the banking entity must be entirely derived from the spread, and not the change in price. Specifically, where a market maker pays a fee, it must be assumed that the market maker has a ready buyer, and resale should take place within one trading day. The only non-customer facing trades must be matched with an existing customer counterparty.

We support the use of compensation as a telling proxy for proprietary trading. Trading firms devote considerable energy constructing the details of the bonus pool, which is tracked scrupulously by individuals trading desks and the firm. The source of the bonus stems from specific trading activity, which can be a valuable source the Agencies seeking to distinguish permissible from prohibited activity.16 As Dennis Kelleher of Better Markets explained, "Reverse engineering the bonus pool (as well as the P&L) will show the Agencies precisely where the money is being made (and lost), by whom and as a result of what activity. This is an invaluable roadmap. The famous saying is as true today as it was decades ago (albeit in a very different context): follow the money and it will lead you to most of the answers you need. . . . Financial institutions and their personnel already collect and precisely track, aggregate, analyze and disseminate every meaningful piece of information related to their business, including all trading, throughout the day and at the end of every day, week, month and quarter. Conveniently, it is all electronically gathered, sorted, stored and can be readily transmitted to any appropriate recipient."17 In response to Question 365 regarding the marginal cost of analyzing trading data, we believe many firms may already maintain records as least as robust as those enumerated in the proposed rule.

No compensation should be awarded for gains on price changes; all compensation shall derive from spreads or fee commissions from trade execution. Such compensation schemes already apply to brokers; by definition, a dealer engages in proprietary trading. Such strict compensation parameters should work to deter evasion.

Esoteric instruments

The Agencies should not permit market making in esoteric, or bespoke instruments that, by nature, serve only one or a few customers, as opposed to a "market." Market making should serve willing investors, both buyers and sellers of existing financial products. The occasional or

[16] See letter on FSOC study on proprietary trading from Dennis Kelleher, Better Markets , Nov. 5, 2010, available at http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-1358

[17] Better Markets

infrequent sale of esoteric products, or products without proven widespread market interest, fails the definition of a market. As Prof. Gerald Epstein observed, the origination and sale of a new or unique financial product does not constitute the intermediation of independent buyers and sellers.18

According to the Senate's Permanent Subcommittee on Investigations, "A key factor in the recent financial crisis was the role played by complex financial instruments, often referred to as structured finance products." These included collateralized debt obligations (CDOs), and credit default swaps (CDS). "These financial products were envisioned, engineered, sold, and traded by major U.S. investment banks." 19 Such structured finance products did not reflect end user demand, then, but an avenue for financial institution profit.20

The intrinsic complexity and axiomatic absence of a market for "bespoke" derivatives means they should play no major role in Section 619-covered market making. Such derivatives aggregate risks, and while some components may figure in liquid markets, others may not, exposing the banking entity to risk and/or a proprietary position.

Time in inventory constitutes a clear method for isolating esoteric instruments. Ideally, time in inventory should not exceed 1 day. Securities that are less liquid, by definition, should be deemed unsuitable for a market making in the trading account. Instruments held for more than one day should be subjected to scrutiny. A number of financial instruments deemed important financial innovations such as CDS and CDO now are dormant; banks such as Bank of America and Citigroup have largely exited these markets. Inventory imbalance must arise as a result of customer-facing transactions. The imbalance should reflect a greater share of customers either purchasing a position held by the market-maker at the higher ask price, or sales by a customer to the market maker at the lower bid price.

Unrealistic valuations of certain complex positions held in the trading account figured in the financial crash. For example, Merrill Lynch's CDO portfolio was valued at $30 billion in June, 2008, but was subsequently sold the next month for $7 billion.21 Had these securities actually traded in an out of Merrill Lynch's account in continuous market, the haircuts would have been less precipitous.

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[18] 12 U.S.C. § 1851 (d)(1)(b)

[19] http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf

[20] "From 2004 to 2008, U.S. financial institutions issued nearly $2.5 trillion in RMBS securities and over $1.4 trillion in CDOs securitizing primarily mortgage related products. Investment banks charged fees ranging from $1 to $8 million to act as the underwriter of an RMBS securitization, and from $5 to $10 million to act as the placement agent for a CDO securitization. Those fees contributed substantial revenues to the investment banks which set up structured finance groups, and a variety of RMBS and CDO origination and trading desks within those groups, to handle mortgage related securitizations. Investment banks placed these securities with investors around the world, and helped develop a secondary market where private RMBS and CDO securities could be bought and sold. The investment banks' trading desks participated in those secondary markets, buying and selling RMBS and CDO securities either for their customers or for themselves."
http://hsgac.senate.gov/public/_files/Financial_Crisis/FinancialCrisisReport.pdf

[21] See presentation from Americans for Financial Reform conference, available at:
http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/11/Bill-Hambrecht-Volcker-Rule-Paper-11-9-11.pdf

Complex derivatives may not easily be valued. The application of complex models to measure risk and evaluate the capital held against positions essentially encouraged banks to maximize the complexity of derivatives, not necessarily to serve client needs, but to advantage lower capital requirements. This led to evasion in the mark-to-market effort, where a trader might engage with a confederate at another firm in a transaction to create a value, known as "mark to myth." Market making should be limited to to assets that can be reliably valued in a market where transactions take place on a weekly basis. Bespoke instruments that can't be valued in such a way should either be prohibited, or assessed an appropriate capital charge.

By nature, trading outside a clearinghouse, or OTC trading, signifies the absence of a liquid market.22 Financial positions tailored such that they trade outside an exchange complicate the ability to hedge, an important indicator of legitimate market making. Noted Alliance Bernstein, there are segments of OTC markets where "hedges do not exist."23 Consequently, OTC derivatives transactions should be viewed under traditional terms of banking, and subject to ordinary banking restrictions requiring capital. 24 In other rulemakings under Title VII of Dodd Frank, the Agencies will require various derivatives that are traded over the counter to be cleared through exchanges or clearinghouses. JP Morgan Chairman Jaime Dimon noted, "It is a good thing that standardized derivatives are moving to clearinghouses. This will help standardize contracts, simplify operational procedures, improve regulatory transparency and reduce aggregate counterparty risk."25 Given that the OTC market is roughly thirty times the size of exchange traded derivatives in notional value, reducing bank activity here will address problems of interconnectedness and systemic risk. 26 (Clearing through an exchange will make bid-ask spreads transparent, but alone does not resolve whether a bank engages in market making or proprietary trading.)

The Agencies' attempt to define transactions in illiquid markets provides unsteady direction and may invite evasion. The Agencies observe that "in less liquid markets, such as over-the-counter markets for . . . derivatives, the appropriate indicia of market making-related activities will vary, but should generally include . . . holding oneself out as willing and available to provide liquidity by providing quotes on a regular (but not necessarily continuous) basis." 27We find such a standard difficult to enforce, as the evidence of "holding oneself out as willing" does not lend itself to measurement. "Providing quotes on a regular (but not necessarily continuous) basis" similarly enables evasion, as a proprietary trader might post a quote at a time of little interest in a financial product.

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[22] An OTC arrangement may be appropriate for a block trade where a hedged security is simultaneously traded in an exchange.

[23] Alliance Bernstein. November, 2011 comment letter, available at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0014-0029,

[24] See comment letter of Lynn Stout, UCLA, to FSOC, Nov. 4, 2010.

[25] http://files.shareholder.com/downloads/ONE/1388207203x0x458380/ab2612d5-3629-46c6-ad94-5fd3ac68d23b/2010_JPMC_AnnualReport_.pdf

[26] See p. 483, "Proposed Regulation of the OTC Market," D'Souza, available at http://www.law.upenn.edu/journals/jbl/articles/volume12/issue2/DSouzaEllisFairchild12U.Pa.J.Bus.L.473%282010%29.pdf

[27] Discussion from Federal Register at 68871

A footnoted clarification [footnote 149] of this standard further discourages: "The frequency of such regular quotations will itself vary; less illiquid markets may involve quotations on a daily or more frequent basis, while highly illiquid markets may trade only by appointment." Under this "appointment" clause a firm that creates a tailored financial product from its existing portfolio of assets and sells it at a profit, can simply assert that it explored the possibility of purchasing such a bespoke product from a random client with whom it meets. Presumably, random clients don't own such bespoke instruments; even in the rare event the client did hold the bespoke product, the proprietary trader might simply decline the client's proposed terms of sale. More importantly, a market that requires a special appointment is, by definition, not a market. A discussion of market-making in bespoke positions should be clarified to add that the banking entity must not only "hold itself out as willing" but demonstrate the purchase as well as sale of a bespoke derivative. The best way to demonstrate this is through the intermediation of two counterparties to a customized derivative.28

The Agencies demonstrate the problem of market making in illiquid instruments in the effort to examine how spread profit and loss would be measured absent conspicuous pricing. "A covered banking entity must identify any trading unit engaged in market making-related activities in an asset class for which the covered banking entity believes bid-ask or similar spreads are not widely disseminated on a consistent basis or are not otherwise reasonably ascertainable and must be able to demonstrate that bid-ask or similar spreads for the asset class are not reasonably ascertainable." The Agencies provide for three proxies: "End of Day Spread Proxy," which is defined as an "estimate" or is "implied;" "Historical Data Spread Proxy" which is a proxy based on "historical bid-ask or similar spread data in similar market conditions;" or "Any other proxy that the banking entity can demonstrate accurately reflects prevailing bid-ask or similar spreads for transactions in the specific asset class."29 This permission for estimates, implications or "any other proxy" evidences the absence of a concrete spread. Where there is no customer expressing an interest at a price, there is clearly no market.

OTC trading should be deemed non market-making absent the existence of two counterparties unrelated to the banking entity. 30

The Agencies should also consider the FAS 157 fair value hierarchy, and eliminate level 3 instruments from permitted market making.[31]

In Question 44, the Agencies ask about positions where the market risk cannot be hedged in a two-way market. Presumably, such assets are illiquid as in over-the-counter derivatives. These should be included as trading account positions and restricted accordingly.

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[28] We note that the term "over the counter" appears only five times in the 298 page document, suggesting inattention to this arena ripe for evasion.

[29] Proposed Rules, Appendix A, Federal Register 68959

[30] JP Morgan formally embraced these principles in a report to shareholders, declaring that "exotic products are smaller in size and more transparent." See p. 22 http://files.shareholder.com/downloads/ONE/1388207203x0x458380/ab2612d5-3629-46c6-ad94-5fd3ac68d23b/2010_JPMC_AnnualReport_.pdf

[31] "Summary of Statement 157," Financial Accounting Standards Board, Available at http://www.fasb.org/summary/stsum157.shtml

In Question 83, the Agencies ask about the impact of proposed parameters guiding permitted market making on the "liquidity … of capital markets." This concern has generated response from industry in the form of comment letters from industry and government officials in Canada and Japan, along with at least two studies financed by the Securities Industry and Financial Markets Association. We believe that studies by the consulting firm of Oliver Wyman and by Stanford University's Dr. Darrell Duffie offer concerns built on questionable assumptions. Moreover, both studies acknowledge that liquidity now provided by insured banks would be replaced by uninsured institutions.

The Oliver Wyman study overstates any costs to markets by using liquidity data from the financial crisis. Factors including panic and a dislocation of prices characterized this period. The Volcker Rule cannot be assumed to lead to identical results.

Both the Oliver Wyman and Duffie studies acknowledge that liquidity will move to other institutions. If providing liquidity is profitable, then other institutions not backed with government guarantees will replace insured institutions. The Oliver Wyman study acknowledges this prospect, though the authors reduce this observation to a footnote. Duffie makes a similar observation: "Eventually, non-bank providers of market-making services would fill some or all of the lost market making capacity." 32 Wallace Turbeville, a former Goldman Sachs banker, and witness at House financial services subcommittee hearing January 18, 2012 on behalf of Americans for Financial Reform, of which Public Citizen is a member, testified that proprietary trading will simply exit the taxpayer-insured banks and "move across the street." 33

Market evidence also suggests that liquidity warnings may be overstated. In January, even as some banks have reportedly reduced or terminated their proprietary trading desks, volume in some of the less liquid instruments such as "junk" bonds has proven strong. One news account: "Junk-bond trades are increasing after average daily volumes reached a more than three-year low in December as Europe's worsening debt crisis limited risk-taking, data from Finra's Trace system show.'This rise in volume is a strong indication that brokerage houses were crying wolf about the reduced liquidity that was supposedly resulting from the anticipated implementation of the Volcker Rule,' said Martin Fridson, global credit strategist at BNP Paribas Investment Partners."34

Economists understand that liquidity can be vulnerable to "liquidity spirals"where high market liquidity during one period precipitates a precipitous decline in liquidity during the next period. High market liquidity drives up asset prices, supporting increased leverage, which drives prices higher still. When true asset prices become understood, speculators sell in fire sales.35

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[32]" Market Making Under the Proposed Volcker Rule," by Darrell Duffie, Stanford University January 16, 2012

[33] Testimony,available at: http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=274322

[34] "Junk-Bond Trading Rises to Most Since February" by Joseph Ciolli, Bloomberg News, available at http://www.sfgate.com/cgi-bin/article.cgi?f=/g/a/2012/01/26/bloomberg_articlesLYDHMY07SXKX01-LYF14.DTL#ixzz1kbbAUBjF

[35] "Market Liquidity and Funding Liquidity," by Lasse Pederson, http://pages.stern.nyu.edu/~lpederse/papers/Mkt_Fun_Liquidity.pdf; also "Deciphering the Liquidity and Credit

New York University Lasse Pederson summarized: NYU economist Lasse Pederson summarizes the situation:36 "In the years preceding the crisis, the global financial markets were flush with liquidity due to low interest rates, high savings rates in Asia, economic growth, and low volatility. As a response to low borrowing costs and low apparent risk, financial institutions became highly levered (a positive liquidity spiral). This made them vulnerable. When house prices started to decline and it started to become clear in 2007 that subprime borrowers would default in large numbers, an adverse liquidity spiral was kicked off. Many banks experienced significant mark-to-market losses, and two hedge funds at Bear Stearns blew up due to subprime-related collateralized debt obligations (CDOs) in June 2007. Market liquidity dried up in one market after another as volatility picked up, funding became tight, and risk premia rose…"

Firms found themselves compelled to seek proprietary profit, and liquidity became an indicator of danger, not systemic prudence.37 Citigroup's Chuck Prince explained: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." 38

Importantly, liquidity does not equate with real economic health. A recent study by Stern School Prof. Thomas Philippon found that growth in financial sector activities and liquidity provision has not been associated with more real economic investment or growth. He examined financial intermediation in the United States over the past 140 years and found that the industry has become less efficient. "The unit cost of intermediation is higher today than it was a century ago. Improvements in information technology seem to have been cancelled out by increases in trading activities whose social value is difficult to assess." For many decades, Glass-Steagall rules walled off large amounts of depository capital from financial markets with no apparent economic ill effects at all.39

Other proprietary trading

The Volcker Rule prohibits proprietary trading, defined as "engaging as a principal for the trading account of the banking entity . . . to purchase or sell . .. any security, any derivative." While the statute defines a trading account as one used "principally" for near term transactions, it neither defines a specific time for "near term," nor excludes transactions that are not "near term." As Crotty, Epstein and Levina argued, "The Volcker Rule must utilize a broad

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Crunch 2007–2008," by Markus Brunnermeier, available at: http://scholar.princeton.edu/markus/files/liquidity_credit_crunch.pdf and other cites

[36] "When Everyone Runs for the Exit," by Lasse Pederson, available at: http://pages.stern.nyu.edu/~lpederse/papers/EveryoneRunsForExit.pdf

[37] Berman, Dennis K. 2007. "Sketchy Loans Abound: With Capital Plentiful, Debt Buyers Take Subprime-Type Risk." *Wall Street Journal*, March 27, page C1.

[38] Nakamoto, Michiyo, and David Wighton. 2007. "Citigroup Chief Stays Bullish on Buyouts." *Financial Times,* July 9, 2007.

[39] Philippon, Thomas, Has the U.S. Finance Industry Become Less Efficient? (December 2011). NYU Working Paper No. FIN-11-037. Available at SSRN: http://ssrn.com/abstract=1972808

definition of proprietary trading, investment and position taking if it is going to succeed." 40 Beyond short-term trading, or trading "principally for the purpose of selling in the near term," the Agencies must acknowledge that at least a minority of positions may be held for a longer period. At Goldman Sachs, 32 percent of financial instruments remain on its books for more than three months, and 8 percent for at least a year.41

The "big short" at Goldman Sachs, for example, did not play out over the course of a day, or even sixty days, but over a period of months. 42 "Morgan Stanley's disastrous 2007 subprime mortgage bet, which lost almost $10 billion, was on the bank's books for almost a year," observed the New York Times. In some cases, firms failed to find buyers for these positions owing to their poor quality.43 44 Positions that proved fatal at Long Term Capital Management were held outside this sixty day window.45 In some cases, firms may have held positions in the trading account because they could not be sold. 46

The Agencies establish a rebuttable presumption that an account used to acquire or take a covered financial position that is held for sixty days or less automatically qualifies as a trading account subject to special scrutiny for prohibited proprietary trading.47 Such a rebuttable presumption serves as a useful method of organizing compliance examination. Such a clear line, nevertheless, may invite gaming, or otherwise motivate a banking entity from holding positions longer than this period. One remedy is to establish a longer window. The statute does not confine the Agencies to a specific period.

The rebuttable presumption that any account used to acquire or take a covered financial position that is held for sixty days or less is a trading account should be expanded to one year, unless the banking entity can demonstrate that the position was not acquired principally for short-term trading purposes. One year demarks tax law covering short-term capital gains.

Leading to the financial crisis, some banking entities evaded stricter capital requirements that applied to the banking account by shifting poor assets, such as CDOs, to the trading account, where the firm faced laxer capital and leverage rules. Some of these CDOs sat on the trading account for more than a year. The Agencies propose to correct this with the application the new Market Risk Capital Rules (Subpart B, 13.3(b)(2)(i)(B). Even if the firm cannot sell these products while obliging conflict of interest prohibitions, they will be required to post additional capital, and reduce leverage. The trading account must not be used as a refuse heap. (These

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[40] " Proprietary Trading Is A Bigger Deal Than Many Bankers And Pundits Claim," by James Crotty. Gerald Epstein and Iren Levina, Political Economy Research Institute, University of Massachusetts, Amherst

[41] "Rule Might Help Goldman's Return on Equity," Reuters, February 8, 2012, available at http://www.reuters.com/article/2012/02/08/goldman-volcker-idUSL2E8D83JX20120208

[42] Omarova, "23a Exemptions"

[43] http://www.nytimes.com/2011/10/10/business/volcker-rule-could-leave-some-murky-wiggle-room.html?_r=1

[44] "Subprime Suspect: The Rise and Fall of Wall Street's First Black CEO," by John Cassidy, New New Yorker, Mar. 31, 2008, at 78, 86-88.

[45] On Long-Term Capital Management, see "When Genius Failed," by Roger Lowestein, 2001, 102-10 .

[46] See Merrill Lynch's positions: John Cassidy, *Subprime Suspect: The Rise and Fall of Wall Street's First Black C.E.O.*, New Yorker, Mar. 31, 2008, at 78, 86-88

[47] Proposed Rules, Section __.3(b)(2)(ii).

Market Risk Capital Rules are themselves the subject of rulemaking to strengthen this prudential safeguard. 48)

Certain complex derivatives originated by the bank should be accounted for under the banking book, with appropriate capital standards, if they cannot be resold immediately. Section 13(d)(1)(b) provides that underwriting and market making be limited to the near term demands of customers.49

The statute also provides authority for the Agencies to address banking entity origination of derivatives under the so-called prudential backstop.50 This statutory language can be deployed the reverse a history of deregulatory decisions regarding bank deployment of derivatives. Using liberal interpretations of the National Bank Act of 1863, the OCC issued a series of interpretations of the "business of banking" clause to authorize bank trafficking in derivatives successively arguing that such instruments "look-through" the original credit instrument, serve as the "functional equivalency" of the loan, or qualify under an "elastic definition" approach. 51 The result, played out in the financial crisis of 2008, meant that the business of banking expanded to "unlimited financial intermediation," according to Saule Omarova, professor at the University of North Carolina. By enabling the largest U.S. banks to buy and sell "financial risk of any kind," the banks "crumbled under the weight of mispriced and misunderstood risk on their books." 52 Applying Section 619 statutory authority to prevent high risk or systemically destabilizing activity, the Agencies can return to the question of whether banking entities should traffic in derivatives. JPMorgan measures its assets in the billions of dollars, but the notional value of its derivatives are measured in the trillions of dollars. Certain derivatives may be too risky for the financial system, including those that cannot be hedged, or are too opaque to price accurately; the Agencies should disallow these instruments under the prudential backstop provisions of the statute. Omarova has asserted that serious risks rest in long term proprietary positions that are separate from market-making, underwriting and credit extensions. 53

The statute's extensive list of financial positions subject to the prohibition on proprietary trading includes "any position, including any long, short, synthetic or other position, in: (A) A security, including an option on a security; (B) A derivative, including an option on a derivative; or (C) A contract of sale of a commodity for future delivery, or option on a contract of sale of a commodity for future delivery."

The Agencies interpret this as a finite list of prohibitions and then accord explicit permission for proprietary trading in other financial positions, including a loan, a commodity, foreign exchange or currency. Such explicit exemption should be removed. Permissions for proprietary trading in

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[48]Market risk capital rules: http://www.occ.treas.gov/topics/capital-policy/market-risk/index-market-risk.html
[49] 12 U.S.C. § 1851d(1)(b)
[50] 12 U.S.C. § 1851(d)(2)(A)(ii)
[51] "The Quiet Metamorphosis : How Derivatives Changed the 'Business of Banking,'" by Saule T. Omarova, Univ of Miami, Oct, 2009.
[52] "The Quiet Metamorphosis : How Derivatives Changed the 'Business of Banking,'" by Saule T. Omarova, Univ of Miami, Oct, 2009.
[53] "From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23a of the Federal Reserve Act," by Saule T. Omarova, draft, 2-27-11.

these financial positions may result in the unintended result of concentrated risk or even market manipulation, as banks feel comforted that such arenas will be free from scrutiny.

The Agencies define a "loan" as "any loan, lease, extension of credit, or secured or unsecured receivable."54 The CFTC and the SEC have issued proposed rules further defining "swap' and "securities based swap," among other things.55 These rules and the related discussion constitute an exhaustive analysis, over 82 pages of the Federal Register, of the categorization of derivatives as compared with loans and other contracts. The Agencies' attempt to define and exempt loans and these related positions through this novel language is inappropriate.The layered exclusion should be abandoned in favor of reliance on the further definition of swaps and security-based swaps by the CFTC and the SEC.

Merchant Banking

The Agencies leave unaddressed the issue of merchant banking, such as the Goldman Sachs investment in Facebook. Such investments challenge the boundaries of proprietary trading and the separation of commerce and banking (a foundational banking principle).

We ask that no such long term positions be maintained other than as extensions of credit repaid in interest and principle, and not price appreciation such as through a subsequent IPO that either enhances or devalues the initial position.

Market-Making and other Hedging

Where an inventory imbalance arises during permitted market-making, such as when a market maker accepts a disproportion of transactions at either the posted bid or ask, the market maker must engage in a hedge. Absence of such a hedge in an inventory imbalance, in fact, may evidence proprietary trading. As the Agencies appropriately note, "Whereas a market maker attempts to eliminate some or all of the price risks . . . by hedging . . . a proprietary trader seeks to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability."56

Hedging, by nature, is imperfect. As the Agencies observe, "Although it may be possible to hedge the risks posed by one or more positions, the cost of doing so may be so high as to effectively make market making in those positions uneconomic if complete hedges were acquired." As a consequence, the imperfection of the hedge should signal potential disqualification of the underlying position from permitted market making. As previously noted,

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[54] Proposed Rules, Section __.2(q).
[55] Federal Register at 29918.
[56] Federal Register at 68961

Alliance Bernstein has asserted that there are segments of OTC markets where hedging isn't available.57

The Agencies' discussion in Appendix B of the role of risk-retention and hedging provides uneven guidance. The Agencies observe that "typically, a market maker holds at least some risk with respect to price movements of retained principal positions and risks. As a result, the market maker also incurs losses or generates profits as price movements actually occur, but such losses or profits are incidental to customer revenues and significantly limited by the banking entity's hedging activities." 58 While the Agencies declare that "customer revenues, not revenues from price movements, predominate," clearer metrics should eventually be adopted. The fact that "the appropriate proportion of customer revenues to profits and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved" should provide navigation to firms and their supervisors as to which markets are suitable, and which should be avoided for legitimate market-making.

Generally, the Agencies should be mindful of permissions for hedging since market making under Section 619 will be fundamentally different than what prevailed before adoption of the law. Specifically, the Agencies propose both useful and troubling guidelines.

Encouraging elements in the proposed rule include:

--In 5(b)(2)(ii), the hedge must be tied to a "specific risk." The banking entity will be required to identify such as risk.59
--In 5(b)(2)(iv), a hedge should "not give rise, at the inception of the hedge, to significant exposures that were not already present." That is, the hedge must be risk-reducing at the inception of the hedge.
--Compensation controls appropriately apply to hedging, as provided in 5(b)(vi).

Yet the Agencies make a number of observations that undermine these clear directives:

The statute permits risk mitigating hedging activities "to reduce the specific risks to the banking entity." The proposed rule restates this at the beginning of 5(b)(2)(ii), but then adds critical disjunctives in describing the panoply of risks, including "market risk, counterparty or other credit risk, currency or foreign exchange risk, interest rate risk, basis risk, or similar risks, arising in connection with and related to individual or aggregated positions, contracts, or other holdings of a covered banking entity."60 Under this expansive list, which includes "aggregated positions," a firm might justify nearly any hedge that might actually serve proprietary trading.

The Agencies permit portfolio hedging. Since the Agencies acknowledge the inherent imperfection of hedging, there is little reliable mechanism to measure how well portfolio hedging would accomplish its task. Some observers noted that permission for portfolio-based hedging "in

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[57] Alliance Bernstein, November, 2011 comment letter, available at http://www.regulations.gov/#!documentDetail;D=OCC-2011-0014-0029,
[58] Federal Register, at p. 68960,
[59] Federal Register, at p. 68875.
[60] Proposed Rules, Section 5(b)(2).

effect, opens the door for banks to make all manner of bets on the market." 61 Portfolio hedging should not be allowed above the desk level unless the bank has the capacity to aggregate risk measurement across the institution with precision. In general, portfolio hedging should be allowed only with proven models.

Portfolio hedging may also serve as an indicator of the imperfections of hedging at the desk level, and can direct examiners to challenge the integrity of specific hedges.

Similarly, the Agencies will permit hedging for "other risks" that "may be difficult or impossible to hedge with anything greater than partial correlation."62 In such cases where only "partial correlation" is available, the Agencies should prohibit traffic in the underlying position.
The Agencies' discussion of the fifth criteria in 5(b)(2)(iv) requires that "the hedging transaction not give rise, at the inception of the hedge, to significant exposures that are not themselves hedged in a contemporaneous transaction" provides solid direction. "A transaction that creates significant new risk exposure that is not itself hedged at the same time would appear to be indicative of prohibited proprietary trading. For example, over-hedging, correlation trading, or pairs trading strategies that generate profits through speculative, proprietary risk-taking would fail to meet this criterion. Similarly, a transaction involving a pair of positions that hedge each other with respect to one type of risk exposure, but create or contain a residual risk exposure would, taken together, constitute prohibited proprietary trading and not risk-mitigating hedging if those positions were taken collectively for the purpose of profiting from short-term movements in the effective price of the residual risk exposure."63

We ask clarification in the Agencies' effort to distinguish "reasonable" from "tangential" hedge correlation. The Agencies explain that a hedge must be "reasonably correlated, based upon the facts and circumstances of the underlying and hedging positions and the risks and liquidity of those positions, to the risk or risks the transaction is intended to hedge or otherwise mitigate. A transaction that is only tangentially related to the risks that it purportedly mitigates may indicate prohibited proprietary trading. Importantly, the Agencies have not proposed that a transaction relying on the hedging exemption be fully correlated; instead, only reasonable correlation is required." 64 To clarify, the Agencies should consider that hedging be measured through congruence. A hedge that accommodates a subset of the risks of a position may be permitted, but not a hedge that covers risks outside those of this permission.

The Agencies will require hedge monitoring, but it should be emphasized that the existence of management should not alone substantiate the legitimacy of the hedge or its congruence.65 Dynamic hedging also deserves scrutiny. In criterion three, the Agencies recognize the legitimacy of "a series of hedging transactions designed to hedge movements in the price of a portfolio of positions. For example, a banking entity may need to engage in dynamic hedging, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the

[61] Available at: http://www.advancedtrading.com/blogs/231601974
[62] Federal Register at 68875
[63] Federal Register at 68876
[64] Federal Register at p. 68875
[65] Federal Register at p. 68876.

individual or aggregated positions, contracts, or other holdings. The Agencies recognize that, in such dynamic hedging, material changes in risk may require a corresponding modification to the banking entity's current hedge positions."66

Occasions may justify recalibration of hedging. If the dynamically managed risks exist at the inception of the "hedge," however, the transaction was not properly hedged at the outset. The Agencies should clarify this point, and require firms to prove that dynamic hedging steps were unavailable except owing to emerging, unforeseen events.

We believe a banking entity may transact market making trades involving synthetic derivatives where it serves as intermediary between two counterparties. The banking entity must not serve as counterparty to a synthetic derivative except where this is closely correlated to an underlying position in the form of a hedge for another inventory position that will shortly be resold. In this case, the synthetic derivative must be such that it can be unwound with sale of the hedged position. As these circumstances may be difficult to decode, existence of the bank's positions as counterparty to a synthetic hedge should be a signal for careful scrutiny.

Diversification may be a common strategy for the average investor in portfolio management, but should not be allowed as a hedging strategy. Diversification could be used to justify essentially any transaction, including prohibited proprietary trades. In a Senate colloquoy, Sen. Jeff Merkley explained, "purchasing commodity futures to 'hedge' inflation risks that may generally impact the banking entity may be nothing more than proprietary trading under another name." 67

In sum, where close correlation between position and hedge appears unattainable, the market should be deemed inappropriate for bank affiliates.

Repurchase agreements

The Agencies' treatment of repurchase agreements (so-called "repos") ignores the role that these transactions play in generating the liquidity that enables proprietary trading. Banking entities that engage in proprietary trading do not use deposits or capital to fund positions. Instead, they borrow the funds – mostly from other financial institutions – in short-term, wholesale capital markets. The major source of funding is repurchase agreements. Between 2001 and 2007, outstanding repurchase agreements burgeoned from $1 trillion to $4.3 trillion. This four-fold increase in repo debt didn't finance traditional users of credit, as the economy certainly didn't grow by either this multiple or any amount close to it. Rather, "Proprietary trading was the primary activity driving the unprecedented increase in the borrowing of financial institutions and growth in their debt," according to Prof. Jane D'Arista. 68

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[66] Federal Register at p.68875.

[67] Congressional Record, July 15, 2010, S5896.

[68] Discussed in "An Interview with Jane D'Arista on the Volcker Rule," with Mike Konczal, Rortybomb, available at http://rortybomb.wordpress.com/2010/04/30/an-interview-with-jane-darista-on-volcker-rule/ , also, from personal email, Oct. 7, 2011.

Affirmed Nick Dunbar, author of "The Devil's Derivatives," the principal weakness of the proposed rule is the permission for repurchase agreement transactions.69

Repos are used not just to finance proprietary trading, but as a form of proprietary trading. Methods for using repos to engage in proprietary trading include shorting, basis trades and put options. In shorting, a bank enters a reverse repo with a counterparty using bonds as collateral. The bank then sells the bond, anticipating that the price of the bond will decline. When the bond must be returned, the bank purchases it in the open market, ideally at a price lower than when the bank sold this debt. In a basis trade, the bank enters a reverse repo with a counterparty, using securities as collateral. Later, the bank returns "substantially equivalent" securities instead of the original securities. The bank essentially invests long in the initial security it takes in as collateral, and becomes short in the "substantially equivalent" security that it returns to its counterparty. With put options, the bank repos securities in exchange for cash. If the borrower fails to return the securities, either due to an outright default or pursuant to an embedded right to refuse delivery, the bank has essentially sold the securities.70

Such transactions have evaded surveillance before. Lehman Brothers used repurchase agreements extensively, but disguised their effect on its leverage by accounting for the transactions as sales. The SEC's surveillance of Lehman's repo activity relied on self-reporting. Noted SEC Chair Schapiro, "The Commission did not perform an audit of Lehman's balance sheet. Instead, the Commission depended on the integrity of the balance sheet information provided by Lehman's management."71 This dynamic argues for a rigorous application of the statute's prudential backstop as provided in 13(d)(2)(a)

The Agencies justify the exclusion of repurchase agreements based on an overly narrow view of their purpose: "Positions held under a repurchase or reverse repurchase agreement operate in economic substance as a secured loan, and are not based on expected or anticipated movements in asset prices."72 If this statement were correct, then there would be no need to exempt repurchase agreements from the ban on proprietary trading. In that case, the proposal to exempt repos would be an unwarranted safe harbor that could provide ground for strategic gaming of other aspects of the Volcker Rule. But the Agencies' statement regarding repos is incorrect. Repos can be used as a means of proprietary trading. Therefore, the proposed exemption would directly undermine the proprietary trading ban without justification.

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[69] The Agencies declare that that repurchase and reverse repurchase agreements are, in substance, secured loans and not short-term trades. Such an exclusion may serve legitimate end-user borrowers who require short term liquidity, a valuable service a bank can provide. Section 610 provides additional powers for the Agencies to police exposures to repurchase agreements, derivatives, and securities lending relationships. Section 610 revises the national bank lending limit to include "any credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction" between a national bank and such person.

[70] Discussion of these issues is contained in "What's Wrong with the Repo Exclusion," from Occupy Wall Street, available at http://occupythesec.nycga.net/2011/12/15/volcker-rule-round-one-whats-wrong-with-the-repo-exclusion/

[71] http://www.house.gov/apps/list/hearing/financialsvcs_dem/schapiro_4.20.10.pdf

[72] Federal Register at 68862

In Section 13(b)(2)(iii)(A), the Agencies provide broad permission for repurchase agreements, stating that the "proposed rule's definition of trading account provides that an account will not be a trading account to the extent that such account is used to acquire or take one or more covered financial positions that arise under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing at the start of the transaction, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty."[73]

This constitutes an unwarranted safe harbor.

While the Agencies require a liquidity management plan that may address the use of repurchase agreements, the proposed rule outlines few specific criteria.[74] A firm may simply declare that repurchase agreements are held for such liquidity management purposes.

The Agencies also fail to delineate the specific types of instruments appropriate for liquidity-management repurchase agreements. Risk varies across asset classes, and the haircuts experienced in the crash for mortgage-related products demonstrated the need for attention to such issues. Basel III, for example, requires that no more than 40 percent of a liquidity pool be composed of high quality corporate and mortgage bonds as opposed to cash and government bonds. (Basel III rules should not be assumed as a model standard; simply an example of greater attention to detail.) Only exchange traded instruments should be permitted. The Agencies should also be mindful of the risk of crowded trades and herding, problems central to the financial crisis,[75] (Alone, need for a systemic understanding argues that repurchase agreements should be bridled, not enabled.)

Section 3(b)(2)(iii)(C) of the proposed definition of trading account establishes five criteria, all of which must be met for the account to qualify as providing bona fide liquidity management. Strictly enforced, these criteria may help reduce the abuse of repurchase agreements for proprietary trading.

In response to Question 30, we recommend that the Agencies should delete paragraphs iii (A) and (B) on p. 68946 providing exemptions for repurchase agreements. Further, the Agencies should require documentation detailing the use of liquidity derived from repurchase agreements. Short of circumstances where the liquidity is used to secure a position that will be purchased by a willing customer, the Agencies should consider repurchase agreements a strong indicator of proprietary trading. The absence of a ready customer evidences prohibited proprietary trading.

Should the agencies retain the repurchase agreement permission, the criteria should be strengthened to provide that "any transaction . . . be principally for the purpose of managing the liquidity of the covered banking entity, and not for the purpose of short-term resale" with testable

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[73] Federal Register at 68862

[74] Proposed Rules, Section ___.03(b)(2)(iii)(C).

[75] See International Monetary Fund, Global Financial Stability Report, April 2011, available at http://www.imf.org/external/pubs/ft/gfsr/2011/01/index.htm.

metrics.76 Where repurchase agreements are permitted for liquidity management subject to a liquidity management plan, we ask that the language in 3 (b)(iii)(c)(2) be revised to read: "Requires that any transaction authorized by the plan be for management of liquidity of the banking entity, and not for short-term resale, benefiting from actual or expected short-term price movements, realizing short-term arbitrage profits, or taking a position taken for such short-term purposes." Instead of permitting repurchase agreements "principally" for liquidity management, the Agencies should mandate that such transactions be "solely" for such management.

Section 7(a) proposes recordkeeping requirements for firms with trading assets and liabilities greater than $1 billion. This may appear to exclude certain repurchase agreements. We ask for clarification that repurchase agreements be included in this threshold calculation where they fail to meet qualifications as liquidity management.

Definition of Customer

In Question 99, the Agencies ask whether terms such as "client," "customer," or "counterparty" merit definition for purposes of market-making. A clear definition of a "customer" is imperative. The concept of a customer figures importantly for banking entities, which, after all, should serve customers. Indeed, the statute reshapes the relation between banking entities and customers by prohibiting proprietary trades, permitting trading only on behalf of others such as customers, and prohibiting conflicts of interest between a bank and its customers.

The bank, or a covered fund, or a bank employee, may not be a "customer." Chairman Volcker explained, "When the bank itself is a "customer", i.e., it is trading for its own account, it will almost inevitably find itself, consciously or inadvertently, acting at cross purposes to the interests of an unrelated commercial customer of a bank. "Inside" hedge funds and equity funds with outside partners may generate generous fees for the bank without the test of market pricing, and those same "inside" funds may be favored over outside competition in placing funds for clients. More generally, proprietary trading activity should not be able to profit from knowledge of customer trades."77

Generally, the concept of the customer should be understood as the person or institution served by the banking entity. The legitimate market-maker should respond to customer demand rather than initiate transactions. The latter should be considered an indicator of proprietary trading. We propose that a customer is a person or institution with a continuing relationship in which the banking entity provides one or more financial products or services prior to the time of the transaction, or a relationship initiated by the prospective customer with a view to engaging in transactions. 7879

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[76] Proposed Rules, Section ___.3(b)(2)(iii)(C).

[77] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4

[78] This definition conforms with the proposed definition as described in Question 99. Federal Register at. 68874,

The Agencies discussion of customers in footnote 199 generally hews to this concept that a customer drives the action of the banking entity. However, elastic use of the term, such as defining a customer as "any person on behalf of whom a buy or sell order has been submitted by a broker-dealer" opens the possibility that the person could be the banking entity itself. A banking entity that originates a product and then finds a counterparty should not be viewed as serving customer interest. Counterparties should not be counted as "customers" where the banking entity originates a financial product. [80]

A banking agent that solicits customers is not a market maker, but a sales person. The market-maker may solicit interest for a position in which a client or non-client counterparty has initiated a counterparty interest. A market maker may solicit customers, but may only serve as an intermediary with another customer.

We seek clarification for the discussion of permitted trading on behalf of customers as a riskless principal in (6(b)(ii)): As written, the proposed rule opens the possibility that the banking entity may engage in one side of a transaction with a bona fide customer, but there appears to be no requirement that the bank must have already arranged for another customer on the other side. That is, it appears that the second leg may be exempted, and therefore contradict the concept that the transaction is "riskless." We ask for clarifying language.

Risk Metrics, Reporting and Recordkeeping

Reporting and record keeping requirements will figure prominently in the successful implementation and enforcement of the statute. Ideally, recordkeeping will serve to guide banking entities to comply with a notable change from previous practice, in which proprietary trading and market making were married. The Agencies appropriately note this remedial dynamic as they explain that the "requirements are intended, in particular, to address some of the difficulties associated with (i) identifying permitted market making-related activities and distinguishing such activities from prohibited proprietary trading and (ii) identifying certain trading activities resulting in material exposure to high-risk assets or high-risk trading strategies."81

Reporting will identify activity related to underwriting, and assist the identification of potential conflicts of interest. This reporting regime will necessarily be an evolving process because of the novelty of market making and underwriting free of proprietary gain. The requirements outlined in Appendix A constitute a welcome initiation of a process that is intended to grow into a functioning reporting regime. As noted, "To be effective, this approach requires identification of

[79] Transactions with institutions that are themselves banking entities, algorithm trading (or high frequency trading) , which arguably accounts for the majority of equity trading currently, evidences proprietary trading. http://www.interactivedata.com/uploads/File/2010-Q2/rts/Waters_May2010_HFT_IDC.pdf

[80] The prohibition on conflicts would nevertheless apply with any counterparty.

[81] Federal Register at p. 68883

useful quantitative measurements as well as judgment regarding the type of measurement results that suggest a further review of the trading unit's activity is warranted. The Agencies intend to take a heuristic approach to implementation in this area that recognizes that quantitative measurements can only be usefully identified and employed after a process of substantial public comment, practical experience, and revision."82

While it is understandable that measurement will necessarily evolve somewhat, a moving target also may create uncertainty, as well as opportunities and incentives to engage in undesirable strategic behavior. As such, certain disciplines should apply. The Agencies are assigned roles with respect to the nature of entities under purview. (For example, the OCC will inspect the trading accounts of national banks; the SEC will supervise broker-dealers, etc.) Greater care should be accorded the specific responsibilities of each agency. For the SEC in particular, prudential oversight will be a relatively new mission. Where information from one Agency informs the efforts of another, formal information-sharing procedures should be adopted, and possibly should include automatic triggers for consultation and information sharing among Agencies. Specific responsibilities for developing and implementing the process by the Agencies must be identified. Without clear responsibilities assigned to individuals and offices, the entire process could languish and fail to reach its potential. Question 145 asks about the potential for involvement of the Office of Financial Research ("OFR"). OFR should play a prominent role in the development of analytics that unify measurements across Agency oversight.

The Agencies should establish a timeline with benchmarks for moving the results of recordkeeping from a heuristic approach to one that involves bright lines.
In addition to information gleaned from financial firms, inspection by other observers will be useful. This should include academic observers and even end-users or customers.
Transparency also will be vital. Public scrutiny and feedback will benefit the evolving framework of recordkeeping and the firmer limitations that the Agencies eventually create.
Disclosure is also critical to restoring confidence in the relevant financial markets, institutions and supervisory authorities. The Agencies should require firms to publish their trading account positions. These positions will no longer be proprietary, and therefore firms should have no interest in the privacy of the account. Delayed reporting can allay concerns firms' may have about revealing proprietary trading strategy. Mutual funds, which presumably do have proprietary interest in their trading strategies, list positions specifically. Disclosure of such positions will allow institutional investors and other market participants to ensure that banking entities are not trading against them and help police the statute's conflicts prohibition. At a minimum, banking entities should be required to participate in all reporting systems that currently apply to securities broker-dealers, for example, the TRACE system for bonds.

Specific Risk Measurements

The financial crisis exposed major inadequacies of risk metrics. The Agencies rely on the concepts of Value at Risk ("VaR") and Stress Value at Risk ("Stress VaR"). The emphasis on the use of Stress VaR will be important to guard against excessive risk taking, but additional

[82] Federal Register at p.68883.

attention to specific implementation is warranted. For example, there is no guidance related to Stress VaR other than reference to "a period of significant financial stress." The events preceding the financial crisis demonstrated that that risk measurement tools that appear to predict consequences of market dislocations could not only prove inadequate, but even lead to additional risk-taking.83 To help address this problem, the assumption of a one-day holding period should be expanded, especially for less liquid asset classes. Stress should be measured over a longer period. More sophisticated modeling should be mandated for potential price volatility, such as the Monte Carlo method where data may be distributed abnormally. The Stress VaR should include potential results based on not just periods of turbulence, but also extreme conditions.

Underwriting

The Agencies should develop quantitative measures to detect non-bona fide underwriting, where a banking entity lacks a client that hopes to raise capital, or existing customers expressing interest in a new security, draws too little attention in the Proposed Rules. As with market making, underwriting should be defined in part by the ability of the banking entity to forecast the financial results of the activity. In a bona fide underwriting, the syndicate should expect to earn the underwriting discount agreed to in the purchase contract with the issuer, based on sales allocations and adjusted for specific factors. Managers earn fees in addition. Losses or gains on the positions associated with unsold balance are additional revenue consequences.

Of particular concern is the allocation of unsold balances on the basis of the share of syndicate risk established in an agreement among underwriters. In a bona fide underwriting, unsold balances should be relatively small and should be hedged promptly. (Unsold balances should include all securities remaining in inventory after the syndicate books are closed.) An indicator of non-bona fide underwriting may be apparent if the VaR (un-hedged and uncovered) of the allocated unsold balance that is allocated to a banking entity is large relative to the expected revenue measured by pro rata underwriting spread. This measure should also include the VaR of basis risk in hedges. The threshold percentage should be very low, perhaps 2%.

While not all underwritings proceed as anticipated, bona fide underwritings should generally clear the market. Otherwise the underwriting activity is either not successful for unexpected reasons or is entered into based on motivations different from client service. The standard client-oriented underwriting results in a modest unsold balance. Variation from this merits inquiry. The appropriate level of anticipated unsold balance requires investigation best pursued by the Agencies.

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[83] Development of risk metrics accompanied an increase in risk-taking, leading to the possibility that such rubrics actually encouraged unnecessary risk. Practitioner-turned-philospher Nassim Taleb dismisses the widely accepted value-at-risk model and asserts modern bankers became disrespectful of the "unknown unknowns." Risk observer Nicholas Dunbar argues that bankers shed their "hate-to-lose" posture, and now "love-to-win."

CEO Attestation

The FSOC recommended that CEOs attest to the "effectiveness" of their banks' compliance.[84] However, the proposed rule merely directs the CEO to establish "an appropriate culture of compliance" for reporting provided in Appendix C with no attestation. In response to Question 337, we ask that Appendix C be revised to require a banking entity's CEO to certify annually that the banking entity has in place processes to establish, maintain, enforce, review, and test the program. We further ask that the CEO attest that all violations have been duly reported to the Agencies. Attestation has served as a central remedial tool in the Sarbanes Oxley law.[85]

The statute provides in section 13(f)(3)(A)(ii) that, in the course of providing prime brokerage services to for a covered fund in which a bank-affiliated covered fund has taken an ownership interest, the CEO certify that the bank does not in any way guarantee obligations or performance. The proposal appropriately restates this rule: For prime brokerage for a covered fund in which a bank-affiliated covered fund has taken an ownership interest, the CEO must certify "in writing annually that the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests."[86]

Hedge and private equity funds

After introducing the Volcker Rule proposal with President Obama, Chairman Volcker explained his rationale to the Senate Banking Committee: "The basic point is that there has been, and remains, a strong public interest in providing a "safety net" – in particular, deposit insurance and the provision of liquidity in emergencies – for commercial banks carrying out essential services. There is not, however, a similar rationale for public funds - taxpayer funds - protecting and supporting essentially proprietary and speculative activities. Hedge funds, private equity funds, and trading activities unrelated to customer needs and continuing banking relationships should stand on their own, without the subsidies implied by public support for depository institutions."[87]

The Agencies provide an important framework for implementing the basic intent of the Volcker Rule" with respect to hedge funds in proposed section 17 of the rule. This prudential backstop prohibits transactions that result in a "material exposure by the banking entity to a high-risk asset or a high-risk trading strategy." Such transactions must not "pose a threat to the safety and soundness of the banking entity or the financial stability of the United States." Nor can such

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[84] FSOC study, at p. 3, available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf

[85] Scrushy was found not guilty on all counts by a jury.

[86] Federal Register at 68916

[87] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4

transactions involve or result in a material conflict of interest between the banking entity and its clients, customers, or counterparties.[88]

Although the statute prohibits proprietary trading, a hedge fund that is owned in part or in whole by a banking entity does just that: It takes principal positions with a view to gain from price changes.

Hedge fund strategies also may involve high risk, contradicting the statute's prohibitions against high risk investments and high risk strategies. The failure of Long Term Capital Management in 1998 dramatized how quickly a hedge fund could fail, and how that endangered associated bank lenders. Hedge funds fail regularly. During the financial crash, more than 700 hedge funds failed.[89] Amaranth Advisors lost $5 billion in 2006 because of a failed bet on natural gas prices and failed. Twenty percent of hedge funds closed in 2008.[90] In October, 2011, hedge funds experienced a net withdrawal of $9 billion.[91] During one day in September, 2011, shares in the publicly traded hedge fund Man Group declined by 25 percent.[92] Because of such high risk, rules limit the clients a hedge fund may attract to those who are qualified and sophisticated, capable of absorbing losses. The American taxpayer effectively became linked to these hedge funds, , qualified, sophisticated, willing or not. Banking entities that bailed out associated hedge funds subsequently sought taxpayer bailouts for themselves.[93]

Because the Volcker Rule intends to limit high risk-taking by banking entities, not enable it, hedge funds should play little role in banking entities. The statute mandates limits ownership to no more than 3 percent of a hedge fund and permits the Agencies to establish a lower limit, including no ownership at all. To meet the statutes prudential mandates adequately, the Agencies should consider lower levels.

The statute's primary command on the issue of hedge fund investment is that "a banking entity shall not.. . . acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or private equity fund." To the extent that the statute exempts some investment from this ban, it makes clear that the investment must be "immaterial" and "de minimis." A bank where 3 percent of its capital is invested in hedge funds that reports a substantial or complete loss of that investment would certainly be reflected in a change in the stock price, which is a common measure of "materiality."

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[88] See 68917

[89] http://money.cnn.com/2008/12/18/news/economy/hedge_fund_liquidations/?postversion=2008121817

[90] ttp://www.heidrick.com/PublicationsReports/PublicationsReports/HS%20HF%20Trends%202009%20and%20Beyond.pdf

[91] "The End of Wall Street as they Knew It,"a by Gabriel Sherman, New York magazine, February, 2012, available at: http://nymag.com/print/?/news/features/wall-street-2012-2/

[92] "Man Group Shares Slide 25% After Company Says Assets Declined," Bloomberg, September 28, 2011, available at: http://www.businessweek.com/news/2011-09-28/man-group-shares-slide-25-after-company-says-assets-declined.html

[93] See, e.g., "Test Case on the Charles" by Raj Date, available at http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/6/12_TEST_CASE_ON_THE_CHARLES_files/state%20street%20volcker%20061210.pdf

In addition, to demonstrate high returns that differentiate a hedge fund from a standard mutual fund, the manager is likely to need to engage in high risk investments or high risk strategies. The statute prohibits high risk investments and high risk strategies.

Finally, a banking entity that provides prime brokerage services to unaffiliated funds will gather considerable insider information about trading intentions and volume. This information could direct strategies by the bank-affiliated fund, generating otherwise avoidable conflict of interest for unaffiliated prime brokerage customers.

JPMorgan Chase & Co. explained to shareholders that "we have no issue with the component [of the Volcker Rule] limiting banks from investing substantial amounts of their own capital into hedge funds."94 If the distance from 100 percent ownership to 3 percent is of "no issue" to JP Morgan, the largest sponsor of hedge funds, then the step from 3 to a lesser percent should similarly be "no issue."

In a Senate colloquy, Sen. Jeff Merkley observed that firms advantaging the "de minimis" provision "should maintain only small seed funds, likely to be $5 to $10 million."[95]

Hedge funds may be seeded with as little as $500,000, with the majority seeded with between $3 and $25 million.[96] Of note, the average launch size in 2003 surpassed $5 billion.[97]
Surveys show some appetite for small, new funds. One survey found that 40 percent of institutional investors would be willing to invest in a start-up fund, with a total of 64 percent willing to invest in a fund with less than a year's history.[98] Another survey found that that nearly 70 percent of institutional investors would consider investing in start-up fund. Of these, a third said they would be "comfortable" investing in a fund with less than $50 million in assets.[99][100]
Another survey found that about half of institutional investors would invest in a fund with less than $50 million under management, and 80 percent would invest in a fund with less than $100 million under management. In all surveys, the fund's track record proved paramount to all respondents.[101] Generally, funds that have attracted the most capital are large and boast a successful track record.[102] Because the statute requires that hedge funds can only be offered in conjunction with "bona fide trust, fiduciary, or investment advisory services," it will be difficult

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[94] http://files.shareholder.com/downloads/ONE/1388207203x0x458380/ab2612d5-3629-46c6-ad94-5fd3ac68d23b/2010_JPMC_AnnualReport_.pdf, p. 23
[95] Congressional Record, July 15, 2010, p. S5897.
[96] http://richard-wilson.blogspot.com/2007/10/hedge-fund-seed-capital.html
[97] http://www.eurekahedge.com/news/07_feb_EH_FOF_Key_trends.asp
[98] http://www.cooconnect.com/Content/research_images/614910fd-b3f9-4b05-973d-c322c52ce16f_2011SentimentReport0614.pdf
[99] JP Morgan: "Shifting Investor Sentiment and the Implications for Hedge Fund Managers," available at http://www.jpmorgan.com/cm/BlobServer/pb_investor_survey2010.pdf?blobkey=id&blobwhere=1158601228697&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs
[100] JP Morgan survey, cited in http://www.cooconnect.com/news/details/2011/7/13/institutional-investors-express-greater-interest-in-start-ups-according-to-jp-morgan-survey/2134
[101] http://www.jpmorgan.com/cm/BlobServer/pb_investor_survey2010.pdf?blobkey=id&blobwhere=1158601228697&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs
[102] See p. 6 if JP Morgan survey, at http://www.cooconnect.com/Content/research_images/614910fd-b3f9-4b05-973d-c322c52ce16f_2011SentimentReport0614.pdf

for a bank both to provide such advice and attract new investors to a relatively new, unproven, small fund. As such, we ask the regulators to be vigilant in policing proposals by banking entities to propose significant investments in hedge funds to evade statutory restrictions on size, and obligations to proffer only bona fide investment advice.

The Agencies stray from the statute regarding the question of whether the covered fund may solicit new customers. Under Section 13(d)(1)(G)(ii), the fund must be organized and offered "only to persons that are customers of such services of the banking entity." The proposal states that this section "does not explicitly require that the customer relationship be pre-existing. . . ." This view is mistaken and contradicts the statute directly. Section 13(d)(1)(G)(ii) permits the fund to be offered only to persons who "are" customers, not to persons who become customers after the fund is organized and offered to them. The Agencies note that banking entities have historically raised capital commitments for covered funds from existing customers as well as individuals or entities that have no pre-existing relationship with the banking entity.[103] [104] The historical existence of the practice provides no argument for permitting it to continue. The statute bars many prior practices—doing so is a large part of its purpose—including the much more significant historical practice of owning more than 3% of a hedge fund.

Extensions of Time for Ownership

The Proposed Rules authorize the Board to extend the time for divestment of ownership interests by covered banking entities based on whether the investment would pose a threat to the safety and soundness either of the banking entity or to the financial stability of the United States.[105] Given the prohibition on covered fund ownership, it is not clear how the Board would evaluate these threats. Continued investment that poses a risk should certainly prompt immediate divestiture. But in the absence of such urgent risk, the Board should not simply ratify an extension. The statute provides that an extension must be "in the public interest." Because of the statute's foundational prohibitions on hedge fund ownership, the banking entity should be required to uphold a high standard to justify continued ownership of a high risk venture. The Proposed Rule also directs the Board is to consider the "cost to the covered banking entity of divesting or disposing of the investment within the applicable period…." If the Board considers the cost of divestiture during the applicable period, it should consider how much that cost exceeds the cost of divestment during an extension period. And it should examine the cost not in vacuum, but consider in light of the risks of permitting extended ownership and the benefits of adhering to the rule.

Compensation hedging

Hedge funds may be suitable for some customers, but the problems of high risk exposure they pose for their supervisors—and for the public—derive from enormous fees for hedge fund

[103] Federal Register at p. 68901.
[104] Proposed Rules, Section ___.11.
[105] Proposed Rules, Section ___.12(e).

advisors. In 2007, the 50 largest hedge and private equity funds managers averaged compensation of $588 million. Moreover, because of carried interest rules, these advisors paid far lower tax rates on this compensation. These fees raise the question whether hedge fund management is largely promoted by banks, as opposed to a response to customer demand.

The Agencies permit risk-mitigating hedging activities that are "directly connected to a compensation arrangement with an employee that directly provides investment advisory or other services to the covered fund" in 13(b)(i)(B). This appears to allow the banking entity to invest in the fund so as to generate profit to compensate a banking entity employee who is the hedge fund manager. As such, the banking entity would hold a de facto interest above the 3 percent, cap, be exposed to any losses, and further violate the prohibition on fund ownership in high risk investments. A banking entity employee that provides advisory services should be rewarded by the hedge fund's own profits, and not those linked to the bank's investment in the fund. This hedging permission should be deleted.

Carried Interest

The Agencies propose that covered fund ownership interest should not be calculated using carried interest, including carried interest held by a banking entity employee, where the "sole purpose" is to allow the banking entity or employee "to share in the profits." [106] Carried interests complicate the nature of ownership because they represent claims on the profits of the fund over time. The Agencies characterize carried interest as compensation, in contrast to control and risk exposure. Still, the practical result may be to undermine the general prohibition as the delayed compensation serves as a form of investment.

The favorable tax treatment for carried interest income betrays the foundation for the designation of capital gains advantages based on true ownership. The Agencies' unnecessary declaration regarding this tax preference will reinforce bank management interest in hedge funds, in violation of the statute's clear prohibition on ownership of a hedge fund.

The Agencies should exclude carried interests as an exception from ownership interests.

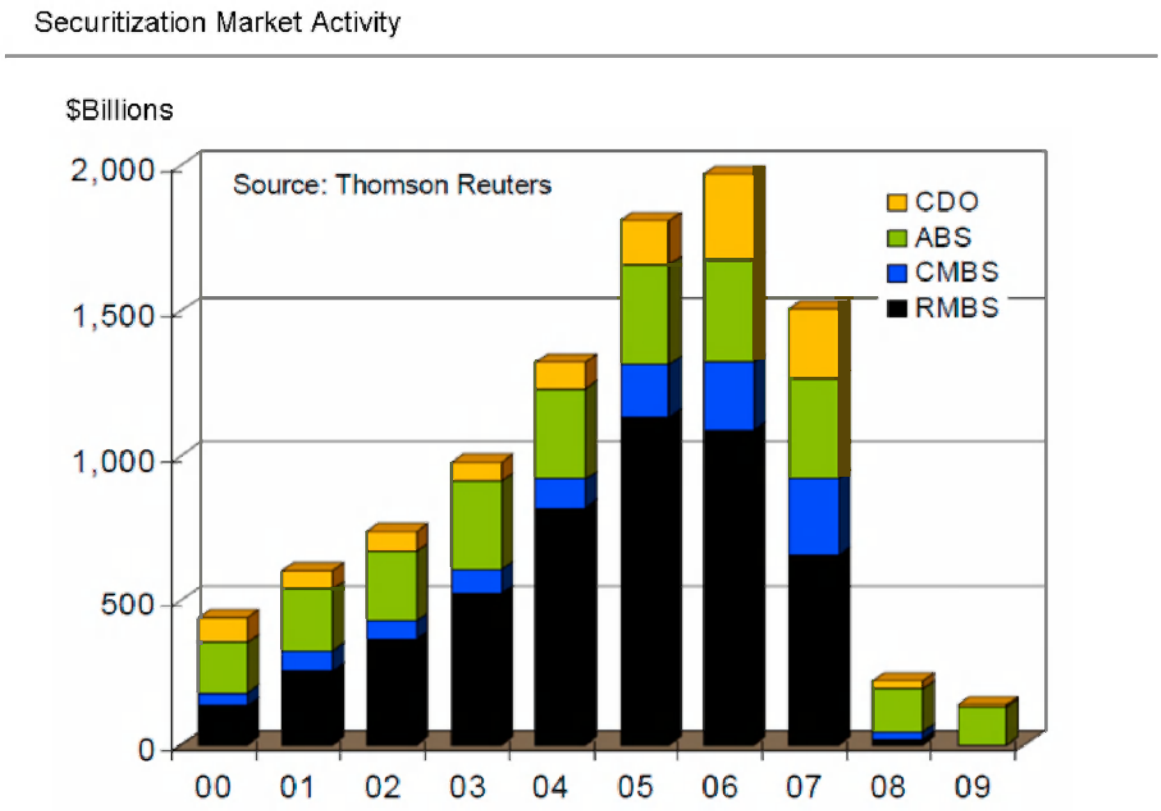
Banking entities that compensate a hedge fund advisor through carried interest obviate the need for compensation hedging.

Securitizations

Securitizations proved a key element in the financial crash. A Federal Reserve study found that the process of securitization provided incentives to originate loans of poor credit quality so as to

[106] Such profits must be distributed promptly. If the profits are not distributed promptly, the reinvested profit "does not share in subsequent profits and losses of the covered fund."

generate fees.107 Federal Reserve supervision director Patrick Parkinson told the FCIC that "the whole concept of the ABS CDOs had been an abomination."108 Observed Erik Sirri, the SEC chief of market regulation, "Deterioration in mortgages spread to the capital markets through securitization."109 The subsequent evaporation of many securities attests to market skepticism about these vehicles today. Total private issuance of asset backed and mortgage backed securities has declined by over 90 percent, from $1.6 trillion in 2006 to about $125 billion in 2010, despite some Federal Reserve backing through the Term Asset Lending Facility.[110] I[111]



As firms attempted to underwrite and make markets with fee-generating securitizations, residual risk became concentrated on their books. Customers purchased higher rated tranches, leaving the banks with assets of lower ratings. During the financial crisis, many securitizations were ultimately bailed out by their sponsoring firms.112

[107] "The Role of the Securitization Process in the Expansion of Subprime Credit," Federal Reserve, available at: http://www.federalreserve.gov/pubs/feds/2009/200928/200928pap.pdf
[108] FCIC, final report, p. 129
[109] http://www.sec.gov/news/testimony/2009/ts031809es.htm
[110] SIFMA data
[111] See Thomson Reuters,
[112] See, e.g., "Test Case on the Charles" by Raj Date, available at http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/6/12_TEST_CASE_ON_THE_CHARLES_files/state%20street%20volcker%20061210.pdf

To protect the lucrative securitization assembly line, some banking entities allegedly failed to acknowledge the true value of mortgages in asset backed securities "fearing their own investors and clients would panic," according to one account. "They ultimately took big write-downs on their mortgage portfolios—totaling hundreds of billions of dollars—throwing markets into turmoil and triggering losses that toppled financial giants Bear Stearns and Lehman Brothers." In one case, authorities are investigating whether traders overvalued an asset backed security by $2.85 billion at Credit Suisse.[113]

The statute provides explicit limitations on securitizations and invites the Agencies to consider adding others as well. First, through the definition of hedge and private equity funds, the statute makes reference to Investment Company Act provisions 3(c)(1) and 3(c)(7). As appropriately reflected in the proposed rule, the covered fund definition means that banking entities may not engage in many common securitizations of asset-backed securities (ABS), including collateralized debt obligations (CDOs) and asset-backed commercial paper (ABCP) conduits.

Second, the statute invites the Agencies to consider excluding additional Investment Company Act registration-exempted securitizations, as described in 13(h)(2). Prohibited fund sponsorship extends not only to the funds specified in the 3(c)(1) and 3(c)(7) provisions of the Investment Company Act, but also to "such similar funds" as the appropriate Agencies "may, by rule … determine."

Third, the statute's definition as to a banking entity's relations with affiliates under 13(h)(1) affords the Agencies the ability to apply the statute's broad prohibitions on proprietary trading as reflected in the proposed. As affiliates, they would be subject to the full scope of Volcker Rule oversight, including the compliance regime.

Finally, the statute limits underwriting and proprietary trading. Specifically, the statute provides in 13(d) that the Agencies "may determine" that underwriting is permitted, but only provided that the underwriting activity is "designed not to exceed the reasonably expected near term demands of clients, customers or counterparties," as delimited in 13(d)(B). Underwriting a securitization, unlike an initial public offering to raise capital for a bona fide customer, is self-generated. Nor is there necessarily client demand for securitizations. One representative prospectus examined by the FCIC called the Kleros Real Estate CDO notes, "There is no market for the Securities … There can be no assurance that a secondary market for any of the Securities will develop."[114]

These broad authorities empower the Agencies to craft important prudential restrictions. We welcome the Agencies' recognition that restrictions "may apply to a significant portion of the outstanding securitization market." Even where securitizations fall outside the Investment Company Act provisions of 3(c)(1) or 3(c)(7) of the Investment Company Act, these issuers would be subject to "(i) The prohibition on proprietary trading; (ii) limitations on investments in and relationships with a covered fund; (iii) the establishment and implementation of a

[113] "U.S. Plans Charges on Bond Fraud," by Susan Pulliam, Wall Street Journal, Feb. 1, 2010.
[114] http://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2006-06-00_Kleros%20Real%20Estate%201_CDO%20Offering%20Circular.pdf

compliance program as required under the proposed rule; and (iv) recordkeeping and reporting requirements."115

As part of a rule of construction, the statute permits loan securitization in 3(g)(2).116 Loan securitization, executed properly, transfers risk from the bank's balance sheet to those investors better positioned to hold long-term exposures to interest rate and other risks. Securitization should be a simple means for long-term investors to invest directly in loans.

The status of this permission as a rule of construction should provide comfort to smaller community banks with no proprietary trading operations. At the same time, the permission for simple loan securitizations designed for firms with no trading account activity should not be viewed as a legal platform for those with active trading desks to engage in otherwise prohibited activity. In a colloquy, Sen. Merkley explained that the rule of construction should not enable loan securitization if "such loans become financial instruments traded to capture the change in their market value." 117

The Agencies correctly reflect the statute's stated permission for securitization of loans by restricting such activity to the plain meaning of what constitutes a loan. A loan is not a security. Therefore securitizations such as collateralized debt obligations, synthetic securitizations, re-securitizations and asset-backed commercial paper conduits that rely on the same exemptions from the Investment Company Act as other covered funds in the statute should not qualify under this permission for loan securitization.

The Agencies should further require that a securitization be risk reducing and designed to only serve clients' needs. The rule should limit the risk firms may hold through significant financial and/or legal liabilities arising from securitizations, including risks associated with retained portions of securitizations, as well as representations and warranties. 118 The Agencies should be particular mindful of dynamics where firms subsidize certain portions of a securitization by retaining complex, illiquid, and highly correlated risks.

The proposal may indicate that the Agencies intend broad permission for securitizations outside the Investment Company Act sections 3(c)(1) or 3(c)(7). For example, the Agencies state in Footnote 71,

> For purposes of the proposed rule, any securitization entity that meets the requirements for an exclusion under Rule 3a–7 or section 3(c)(5) of the Investment Company Act, or any other exclusion or exemption from the definition of "investment company" under the Investment Company Act (other than sections 3(c)(1) or 3(c)(7) of the Investment Company Act), would not be a covered fund under the proposed definition. Additionally,

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[115] Federal Register at p. 68854.

[116] This permission falls under a general category headed "rules of construction" that addresses a miscellany of issues. This includes for example, an unrelated "limitation on contrary authority."

[117] Congressional Record, July 15,2010, available at:
http://graphics8.nytimes.com/packages/pdf/business/Economix-Merkley-Levin-Detailed.pdf

[118] See preamble (Q236, 238)

an issuer of asset-backed securities that is subject to legal documents mandating compliance with the conditions of section 3(c)(1) of 3(c)(7) of the Investment Company Act would not be a covered fund if such issuer also can satisfy all the conditions of an alternative exclusion or exemption for which it is eligible119

The Agencies should instead exercise the statute's authority to consider rules for further securitization limits. This may include, auto loan and credit card securitizations. Many mortgage financing transactions, including those involving real estate investment trusts (REITs), rely on Section 3(c)(5)(C). None of these qualify as simple loan securitizations provided in the statute.

In Question 78, the Agencies ask whether the creation, offer and sale of certain structured securities such as trust preferred securities or tender option bonds that may involve the purchase of another security and repackaging of that security through an intermediate entity be considered a covered activity or included as an exemption under market making or underwriting. Where the bank serves to originate this security, such activity should not qualify as permitted underwriting. Where there is no customer attempting to sell this agglomeration of securities, it should not qualify as market making.120 The statute is intended to refocus banks on serving customers.

In response to Question 301, certain synthetic securitizations and re-securitizations should be proscribed.121 While the Agencies take some care to restrict permission to actual securitizations of loans,122 many re-securitizations were central to proprietary trading activity that the statute was intended to restrain. The proposed rule should ensure that securitizations do not become proprietary trading vehicles, such as managed CDOs and other vehicles that are effectively off-balance sheet, hidden proprietary trading operations for banking entities.

The proposed rule in 2(q) defines a ''loan'' as any loan, lease, extension of credit, or secured or unsecured receivable. This definition is overly broad. The concept of credit extension could be interpreted as essentially any banking activity.

Credit Default Swaps in Securitization

Credit default swaps figured prominently in the financial crash. New York Insurance Commissioner Eric Dinallo in Congressional testimony noted that the notional value of credit default swaps swelled to an estimated $62 trillion in the period before the 2008 crash, yet actual debt amounted to about $16 trillion. In other words, a considerable volume of CDS insurance related to loans in which the CDS holder had no material interest.123 124 Under the apparent rubric of risk-mitigating insurance, the banking system effectively multiplied liability.

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[119] Federal Register at 68854.
[120] Federal Register, pages 68868-68869.
[121] Federal Register, p. 68912
[122] Notably, the agencies provide a safe harbor for legitimate securitization, limited to cash loans, limited derivatives, and other simple structures. (sec. __13(d)) (Q296)
[123] http://www.davispolk.com/1485409/pdfs/Dinallo.pdf

We endorse the Agencies' restrictions on the use of credit default swaps. Section 13(d) of the proposed rule permits a banking entity to own derivatives only to the extent that they hedge ownership of securitized loans, as required by Section 941. As a consequence, §13(d)(3) of the proposed rule would not allow the use of a credit default swap once the banking entity sells asset-backed securities.125 We support the elaboration contained in footnote 303, which states: "The types of derivatives permitted under § 13(d)(3) of the proposed rule are not meant to include a synthetic securitization or a securitization of derivatives, but rather to include those derivatives that are used to hedge foreign exchange or interest rate risk resulting from loans held by the issuer of asset-backed securities."

This brief provision may go far to mitigate hazards that led to the financial crash.

Underwriting

The statute provides under 13(d)(1)(B) a permission for underwritings that "are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." Central to this activity is the satisfaction of client demand and the requirement that the activity "be designed to generate revenues primarily from fees, commissions, underwriting spreads or other income, not from appreciation in value of covered financial positions that the banking entity holds related to such activities or the hedging of such covered financial positions. This proposed requirement should promote investor confidence by ensuring that the activities conducted in reliance on the underwriting exemption are designed to benefit the interests of clients seeking to bring their securities to market, not the interests of the underwriters themselves."126

This serves well to describe the accepted concept of underwriting and conforms with the permission in Section 619. While not risk-free, the banking entity can expect to earn revenue from the underwriting discount. This requires a discernible and sufficiently liquid market for the securities being purchased and distributed. Absent these conditions, the banking entity will be exposed to risk without the prospect of financial reward through fees, commissions, or the underwriting spread.

The proposed rule strays from this principle. The proposed rules depart from the SEC's Regulation M definition of underwriting by allowing selling group members of the underwriting syndicate to enter into an agreement with other selling group members to collectively distribute the securities, rather than requiring all members of a distribution to join the underwriting

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[124] Sen. Jeff Merkley explained the perils such a dynamic exposes as akin to an electrician purchasing fire insurance on your house. – Remarks, Americans for Financial Reform conference, Hart Senate Office Bld, 906 Washington, D.C. Nov. 9, 2011.

[125] Federal Register, Vol 76, 68912 of proposed rule,

[126] Federal Register at 68925

syndicate".127 The SEC's Regulation M does not forbid the deployment of shares to selling group members, but does restrict the definition of "underwriting" to the activities of syndicate members that provide a price guarantee to the issuer. The final rules should clarify that activity as a selling group member does not qualify as "underwriting."
Of lesser note, the preamble explains the underwriting permission as "an exemption from the prohibition on proprietary trading for purchases and sales in connection with underwriting activities."128 We ask the Agencies to clarify that this permission as part of the prohibition on proprietary trading should not itself enable proprietary trading with respect to the underwriting.

Prime Brokerage

The experience of Bear Stearns and its effort to bail out its hedge funds informed Congress as it considered limitations on prime brokerage, as Sen. Jeff Merkley explained in a Senate colloquy.129

In accord with the statutory prohibitions provided under 13(f), the Agencies appropriately propose to prohibit a banking entity that acts as investment adviser or sponsor to a covered fund from engaging in certain transactions with that fund. The proposed rule would specifically apply this ban to all "covered transactions," as set forth in section 23A of the Federal Reserve Act. 130 As provided in the statute, a banking entity can still perform certain "prime brokerage transactions" with a covered fund in which the banking entity has taken an ownership interest. These prime brokerage services would be required to be performed on substantially the same terms as transactions with unaffiliated companies, as provided under section 23B of the Federal Reserve Act. In response to Question 241, we believe the Agencies appropriately implement the statute.

Within these prime brokerage relations, we ask the Agencies to abolish the practice whereby a prime broker borrows a security from a lender without actually depositing cash as collateral with the lender. These "free" loans facilitated enormous cash balances, as the prime brokers, in turn, re-lent the securities to other clients such as hedge funds but required cash collateral.

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[127] Federal Register at 68925
[128] Federal Register, at 68924.
[129] "A large part of protecting firms from bailing out their affiliated funds is by limiting the lending, asset purchases and sales, derivatives trading, and other relationships that a banking entity or nonbank financial company supervised by the Board may maintain with the hedge funds and private equity funds it advises. The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition, or through writing a derivative. Further, providing advisory services to a hedge fund or private equity fund creates a conflict of interest and risk because when a banking entity is itself determining the investment strategy of a fund, it no longer can make a fully independent credit evaluation of the hedge fund or private equity fund borrower. These bailout protections will significantly benefit independent hedge funds and private equity funds, and also improve U.S. financial stability." Available at: http://www.gibsondunn.com/publications/Documents/Dodd-Frank-AppendixB.pdf
[130] This is sometimes know as "Super 23A" because it applies to all entities (rather than just banks) in a banking organization and does not recognize certain standard exemptions available under section 23A.

Where prime brokerage is permitted, we ask for an affirmative declaration by the Federal Reserve Board, as opposed to a determination that "the Board has not determined that such transaction is inconsistent with the safe and sound operation and condition of the covered banking entity." This will conform the proposed rule section 16(a)(2)(ii)(C) with the original statutory language at 619(f)(3)(A)(iii).

Penalties

Because the statute and proposed rule portend major structural changes for large financial institutions that derived significant profit from proprietary trading and hedge funds, strict enforcement will be important to promote compliance. Penalties require lines, which emphasizes the importance that metrics be adopted for various activities.

The proposed rule restates the statute's provisions regarding penalties, providing in Section 21(b) that if "any banking entity has engaged in an impressible activity the relevant Agency may, after due notice and an opportunity for hearing, direct the banking entity to restrict, limit, or terminate the activity and, as relevant, dispose of the investment." Alone, such a penalty neither holds violators accountable nor deters future infractions.

Whereas the preamble explores most other provisions of the statute at length, the Agencies consider the subject of penalties with little elaboration. For example, of the roughly 1,300 questions, the Agencies ask none on the subject of enforcement and penalties.

The statute does provide more expansive authority, allowing Federal agencies to "further restrict" investments and activities. The Agencies should advantage this statutory language to impose forceful penalties, including restrictions on other banking activities. As part of the Bank Holding Company Act, the Agencies can deploy Section 8 of the BHCA that provides criminal penalties for willful violation, and civil penalties for violation by a company or individual of the BHC Act or any association regulation.131 We note, however, that the frequency of penalties seems disconnected with the obvious problems of the financial industry.132

We welcome indications of Section 8 penalties from two of the agencies. The Treasury states: "Nothing in this part limits in any way the authority of the OCC to impose penalties for violation by any covered banking entity provided under any other applicable statute."133134 This means, for example, that the Federal Deposit Insurance Act provisions apply. Under 12 USC 1818, for example, the Agency may terminate insurance, remove officers, and impose penalties. For example, on Dec. 8, 2011, the OCC cited this statute in a consent order with Wells Fargo

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[131] We note a $100 million fine by the Federal Reserve for infractions including false representations. Available at: http://www.federalreserve.gov/boarddocs/press/enforcement/2003/20031218/attachment.pdf

[132] http://www.bankersonline.com/security/bsapenaltylist.html#hsbc

[133] See "preservation of authority" at Federal Register 68967.

[134] The OCC publishes enforcement actions, including those where it has exacted fines. http://occ.treas.gov/news-issuances/news-releases/2011/nr-occ-2011-150.html

requiring payment of $20 million in a civil penalty involving unlawful derivatives transactions.135

The Federal Reserve similarly notes the right to "impose penalties for violation by any company or individual." 136

We ask that the FDIC and the SEC add similar language. 137 We lament that securities law limits penalties to the disgorgement of profit, as opposed to a multiple of profit, and join with Chairman Schapiro's recommendation to remedy this deficiency with Congressional reform. 138 In terms of staffing, the SEC also faces challenges. Where the OCC has 60 full-time examiners on site permanently at Citicorp, for example, the SEC visited the largest broker dealers with a team of a few once every few years, in the period leading to the crash. 139 SEC supervision will be augmented with surveillance by the Financial Industry Regulatory Authority, the industry-governed self-regulatory organization, which generally identifies and refers matters to the SEC. This is a poor substitute for direct government surveillance, but we acknowledge that the remedy, namely additional funding, rests outside the SEC's reach with this rulemaking.

As one of its recommended actions, the FSOC recommended the use of penalties where impermissible proprietary trading is detected.140 The FSOC also recommended that, beyond the termination of activities, the Agencies should consider stricter capital, leverage, and risk limits.141 We agree.

Compliance will depend in no small way on self-reporting, as firms' own record keeping will serve as a primary source of evidence. Supervisors will not be "looking over the shoulders" of traders. This is a source of weakness given firms' ability to doctor their own records to evade the law.

As stated previously, we urge that Appendix C be revised to require a banking entity's CEO to annually certify the integrity of the bank's reporting and compliance program, and that reports include all known violations. This should bolster the integrity of such reports.

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[135] http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-144a.pdf
[136] See "authority," at Federal Register 68968.
[137] FDIC penalties:
http://www.fdic.gov/bank/individual/enforcement/neworders.html
[138] http://www.sec.gov/news/speech/2011/spch120111rk.htm
[139] FCIC report, at p. 153, available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf
[140] FSOC report, p. 3, available at
http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf
[141] FSOC report on Proprietary Trading, p. 6, available at
http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf

Conflicts of Interest

Leading to approval of the statute, the Senate Permanent Subcommittee on Investigations reviewed a series of transactions by Goldman Sachs in which Goldman allegedly took positions in conflict with its clients.[142] A bipartisan Senate Subcommittee concluded that such transactions were unethical and contributed to the financial crisis,[143] and suggested that regulators "implementing the conflict of interest prohibitions in Sections 619 and 621 should consider the types of conflicts of interest in the Goldman Sachs case study."[144] Viewed in this context, the conflict of interest limitation in the statute serves three principal functions: it imposes fiduciary-like obligations on institutions that might otherwise engage in self-dealing transactions with their clients, prevents conflicts of interest to preserve banks' gatekeeper functions, and prohibits certain types of risky transactions that contributed to the financial crisis in 2008.[145] The definition of "material conflict of interest" should thus reflect these purposes. Unfortunately, as currently proposed – with two major loopholes – it does not.

The proposed rule restates the statute's prohibition on conflicts in Section 8(a): "(a) No transaction, class of transactions, or activity may be deemed permissible . . . if the transaction, class of transactions, or activity would: (1) Involve or result in a material conflict of interest between the covered banking entity and its clients, customers, or counterparties." The statute directs the Agencies to "define by rule" what would constitute a conflict. The clear implication of this direction is that the Agencies should define which transactions or activities would run contrary to the interests of a firm's customers. Indeed, the Agencies proffer a definition where "the covered banking entity's interests [are] materially adverse to the interests of its client, customer, or counterparty with respect to such transaction, class of transactions, or activity." However, despite the statute's clear prohibition against conflicts within permitted activities, the Agencies permit conflicts to exist where they are either disclosed to the customer, or where the part of the firm interacting with a customer lacks knowledge of the conflict because of an information barrier. In an apparent attempt to cure this contradiction, the Agencies link disclosure and information barriers to the *definition* of conflicts: "*Definition of material conflict of interest.* A material conflict of interest . . . exists . . . *unless"* the conflict is disclosed or masked behind an information barrier. (Emphasis added.) This is an illogical way to proceed,

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[142] *See* United States Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Government Affairs, Wall Street and the Financial Crisis: Anatomy of a Financial Collapse, Majority and Minority Staff Report, April 13, 2011 (available at http://levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf), at 376-636 [hereinafter Wall Street and the Financial Crisis].

[143] *Id.* at 318-20 (discussing the role of conflicts of interest at investment banks in contributing to the mortgage crisis, and noting that: "Investment banks were a major driving force behind the structured finance products that provided a steady stream of funding for lenders to originate high risk, poor quality loans and that magnified risk throughout the U.S. financial system. The investment banks that engineered, sold, traded, and profited from mortgage related structured finance products were a major cause of the financial crisis."); *id.* at 638 (stating that Sections 619 and 621, "if well implemented, will protect market participants from the self-dealing that contributed to the financial crisis").

[144] *Id.* at 639.

[145] For an extended discussion of how Section 27B and the Volcker Rule impose fiduciary-like obligations and preserve the gatekeeping function, see Andrew F. Tuch, Working Paper, *Conflicted Gatekeepers: The Volcker Rule and Goldman Sachs*, April 2011, *available at* http://ssrn.com/abstract=1809271.

and contradicts the underlying statute. A transaction is either conflicted or it is not – disclosing a conflict or hiding it from certain people within the firm does not prevent it from existing. By contrast, the preamble in the proposed regulations for Section 27B (Section 621 of Dodd-Frank, a companion provision also dealing with conflicts of interest in securities transactions) notes that the SEC did not intend to suggest that "a transaction otherwise prohibited under the proposed rule would be permitted if there were adequate disclosure by the securitization participant," and acknowledges potential "practical challenges in relying on disclosure as a means to address all transactions involving a material conflict of interest."[146] The SEC's expressed misgivings about disclosure as a means of escaping liability in Section 27B are entirely well-founded, and should apply equally to the proposed Volcker Rule regulation.

By permitting trading in conflict with customers provided that the conflict is disclosed, the Agencies appear to countenance proprietary trading, which the statute forbids. Adopting a flexible approach would be more sensible if the underlying activity were permissible, but makes little sense in the context of the ban on conflicts, which is a limitation on the narrow exceptions to a categorical ban on proprietary trading. In the case of Goldman Sachs' conflicted transactions, the firm was accused of designing securities that were intended to fail and then taking a short position on those securities. Disclosure does not eliminate the incentive to design or market such faulty instruments, and thereby create shorting opportunities for the banking entity.[147] Had the Volcker Rule applied, Goldman Sachs would have been prevented from shorting the securities in the first place based on the prohibition against proprietary trading. Allowing banking entities to have conflicts of interest, so long as they disclose, inappropriately places the burden of decision on the customer, client, or counterparty, when the focus of the Rule is on instead regulating risky investment decisions by the banking entity. The customer may often be poorly situated to evaluate such disclosures, since the customer may not be privy to the information that the banking entity is using to devise its trading strategy. Further, allowing such transactions to go forward means allowing a category of transactions that Congress determined poses an inherent risk to the stability of the financial system.

Practical problems also arise if regulators allow disclosure. If the banking entity plans to short the relevant instrument but has not yet done so, or even knows that it will likely short the instrument but is not yet certain, it will be difficult to determine what kind of disclosure would reveal the conflict. Waiting until after the banking entity has taken a conflicting position to reveal the conflict would surely be insufficient, even if regulators determine that a present intention to engage in a future transaction itself creates a conflict. Such an intention may not be fully manifest at the time of the transaction with the client or counterparty, and in any case it would be very difficult as a practical matter for enforcement agencies to prove such an intention. Further, even full and accurate disclosure of a conflict does not provide the other party with all the information that would be necessary to evaluate the disclosure or use it as the basis for investment decisions. It is very difficult for the client or counterparty to distinguish these

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[146] Prohibition against Conflicts of Interest in Certain Securitizations, S.E.C. Release No. 34- 65355, at 45-46 (proposed Sept. 19, 2001) (to be codified at 17 C.F.R. pt. 230).

[147] *See* Louise Story & Gretchen Morgenson, *SEC Accuses Goldman Sachs of Fraud in Housing Deal*, NY Times, Apr. 16, 2010, at A1 ("Goldman Sachs, the Wall Street powerhouse, was accused of securities fraud in a civil lawsuit filed Friday by the Securities and Exchange Commission, which claims the bank created and sold a mortgage investment that was secretly intended to fail.").

situations. Unless the Rule requires full disclosure of the banking entity's trading strategy and the rationale behind it, allowing disclosure will permit the banking entity to indemnify itself without adequately mitigating the harm from the conflict.

Disclosure also generates additional problems. Where a legitimate market maker accepts a large block from a buy side institution for resale, for example, the disclosure requirement might compel the market maker to apprise potential clients to whom it intends to sell portions of the block of the magnitude of the overall transaction, which, when completed, may reduce the overall price of the security. Apprised of this market maker's block, the client might instead choose to short the security. Such a dynamic may introduce an impediment in a firm's willingness to engage in block trade market making at the outset, an unnecessary problem for a statute that otherwise permits this activity.

Further, disclosure may perversely affect both the disclosing party and the party to whom information is disclosed. Empirical research on the behavioral effects of conflict of interest disclosure has demonstrated that, in financial transactions, disclosure of conflicts provides moral license to the disclosing party to provide biased advice.[148] That is, disclosure can backfire by alleviating the guilt of the conflicted party. In addition, disclosure can perversely induce the party receiving the disclosure to become more credulous of the disclosing party, since it is then perceived as more trustworthy.[149] Permitting banking entities to have conflicts so long as they are disclosed could thus actually be affirmatively harmful, as it might promote rather than curb the conduct the statute bans.

If the disclosure provision is retained, the Agencies should specify the nature of disclosure required. Burying the disclosure in marketing material or in lengthy paperwork will fail to fulfill this need. The regulations should require the conflicted entity to obtain affirmative consent in writing from its customer for the specific conflicted transaction including the nature of the conflict and the economic value of the conflict to the covered banking entity. Mere notice is insufficient.

Information barriers invite abuse on the part of the company that implements them, and thereby present major enforcement problems. Several recent high-profile scandals involving the breach of internal information barriers, including an SEC enforcement action against Merrill Lynch and the stock research analyst scandals of the early 2000s reflect this problem.[150] Empirical evidence that investment banks make unusually high returns in trading the stock of companies involved in

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[148], "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest," by Daylian M. Cain, George Lowenstein, & Don A. Moore 34 J. LEGAL STUD. 1 (2005); When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest," Daylian M. Cain, George Lowenstein, & Don A. Moore 37 J. Consumer Res. 836 (2011) (presenting the results of four studies that suggest disclosure backfires).

[149] *See id.* at 5-6; Fiona Lee, Christopher Peterson, and Larissa Z. Tiedens, *Mea Culpa: Predicting Stock Prices from Organizational Attributions*, 30 Personality & Social Psychology Bulletin

[150] See SEC Order Against Merrill Lynch, Pierce, Fenner & Smith Incorporated, 25 March 2011 (available at http://sec.gov/litigation/admin/2011/34-63760.pdf); "The Cheating Culture: Why More Americans Are Doing Wrong To Get Ahead," by David Callahan,152 (2004) ("A second [failure] was the fall of the 'Chinese Wall' that was supposed to separate stock research analysts from investment bankers, providing the incentive for star analysts like Henry Blodget and Jack Grubman to mislead investors on a massive scale.").

merger and acquisition deals that they have advised suggests that they systematically exploit non-public information despite information barriers.[151]

It is difficult to envision how such information barriers could operate in practice for all types of material conflicts of interest. For example, in the series of Goldman Sachs transactions that influenced Congress' consideration of the Volcker Rule conflict of interest provision, Goldman made $3.7 billion in gains on its net short positions on mortgages, while several of the mortgage-backed CDOs that Goldman underwrote were worth more than $1 billion each.[152] It defies credibility that the executives of a company that engages in both of these activities on such a large scale could be unaware of one of them and still manage the company competently. Activities within the exceptions to the Volcker Rule – hedging, market making, etc. – could easily involve such large sums. The walled off entities would then have to operate essentially as separate companies. The information barrier effectively mandates that no single officer be aware of the firm's collective operations, a policy that undermines Dodd-Frank's injunction to promote sound management, ensure financial stability, and reduce systemic risk. Even if information barriers might be useful in other contexts, they are not appropriate for the Volcker Rule to the extent that it covers large transactions.

Allowing the banking entity itself to define what it believes to be a "materially adverse effect" on its client would effectively be letting the fox guard the henhouse. Banking entities cannot be released from liability simply because they assert that their clients' material interests have sufficiently been protected by such barriers. Unfortunately the proposed rule could be construed as providing banking entities with such power, since it merely requires that such information barriers be "*reasonably designed* . . . to prevent the conflict of interest from involving or resulting in a materially adverse effect on a client, customer or counterparty."
The study by the Financial Stability Oversight Council expected the Agencies in the implementing rule to fill the gap between what pre-existing law prohibited and the Volcker Rule's broader prohibition. Instead, the proposed rule seems to be coextensive with existing law. According to the study, where there is a gap in existing law where a material conflict is not yet prohibited, "Agencies should consider whether these protections and remedies provide an effective model that can be extended to address the gap, *or whether outright bans are necessary*." (Emphasis added) In addition the Study observed that:

> In implementing the Volcker Rule, Agencies should consider the extent to which the permitted activities present risks that banking entities will conduct transactions that place the banking entity's own interests ahead of its obligations to its customers and counterparties, and where such conflicts might arise, and what steps can be designed to *prevent the banking entity from proceeding with the transaction* in a manner contrary to those obligations. (Emphasis added)

Under the proposed rule the only additional obligation beyond disclosure and information barriers appears to be a judgment by the bank about how badly the transaction will hurt the client, customer, or counterparty. This leaves too much discretion to a bank that does not have

[151] See Andriy Bodnaruk, Massimo Massa & Andrei Simonov," Investment Banks as Insiders and the Market for Corporate Control," Andriy Bodnaruk, Massimo Massa & Andrei Simonov, 22 REV. FIN. STUD. 4989 (2009).
[152] Wall Street and the Financial Crisis, *supra* note 3, at 376, 388-98.

the capability to know all of the transactions and activities of the client, customer, or counterparty. The proposed rule puts the bank in the position of deciding that even if, for example, the disclosure is inadequate, a conflict that would cost the other side a loss of a certain size is acceptable. This is not what the statute provides.

By way of example, both the study and the notice of proposed rulemaking acknowledge a number of transactions that might present material conflicts of interest. These include situations, for example, where the banking entity benefits from an informational advantage due to the complexity or opacity of the transactions or the difficulty in pricing the securities. In addition, a material conflict might exist when a banking entity favors one customer over another. As the FSOC study suggested:

> Agencies should also consider situations where the financial incentives associated with a banking entity's relationship with one customer might create circumstances under which particular benefits might accrue to the bank as a result of treating another customer less favorably.

In the notice of proposed rulemaking, the discussion that precedes the proposed rule tracks this language.[153] However, given the language of the rule itself, there might be situations where a bank favors one customer over another, triggering a conflict of interest where the favored customer and the bank (through higher commissions or other business benefits) profits at the less favored customer's expense. While the statute and the Study identify this as problematic, the proposed rule seems to treat this as acceptable, if it was not otherwise prohibited by pre-Volcker law, and does not have a "material" adverse impact on the disfavored client. This is an unacceptable result, as market distortions and profiting at clients' expense can occur if the bank can continually target its less sophisticated institutional clients and favor its more sophisticated ones.[154]

We ask the Agencies to examine further a sound regime to bar conflicts.

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[153] See 68893. "Similarly, a banking entity may conduct a transaction that places the banking entity's own interests ahead of its obligations to its customers, clients or counterparties, or it may seek to gain by treating one customer involved in a transaction more favorably than another customer involved in that transaction. Concerns regarding conflicts of interest are likely to be elevated when a transaction is complex, highly structured or opaque, involves illiquid or hard-to-value instruments or assets, requires the coordination of multiple internal groups (such as multiple trading desks or affiliated entities), or involves a significant asymmetry of information or transactional data among participants.In all cases, the existence of a material conflict of interest depends on the specific facts and circumstances."

[154] See "The Sophisticated Investor and the Global Financial Crisis," by Jennifer Taub, in Corporate Governance Failures: The Role of Institutional Investors in the Global Financial Crisis, eds., Hawley, Kamath and Williams, April 2011, University of Pennsylvania Press (Banks realize that "there are two types of [sophisticated investors]: (1) those with skills equal to their own, meaning the truly sophisticated, and (2) those institutional investors and real people who qualified under the law as "sophisticated" but who were quite easy to fool.").

Capital Requirements

Section 13(d)(3) provides the Agencies authority to "adopt rules imposing additional capital requirements and quantitative limitations."[155] Capital and leverage requirements have long and reliably served as the core prudential safeguard for financial institutions. As the Agencies refine the parameters of specific activity restrictions, they should use their section 13(d)(3) authority to combat the underlying problem of risk with which the Volcker Rule is concerned.

Large financial institutions failed or faltered in 2008 in large part because they took highly levered proprietary positions. Financial sector debt increased from 63.8 to 113.8 percent of GDP from 1997 to 2007.[156] Institutions increasingly relied on leveraged proprietary trading for profits, a trend sometimes ascribed to the 1975 deregulation of commissions that reduced a once reliable source of revenue. [157][158] High leverage amplified the repercussions of even a modest deterioration of the underlying asset. In practice, the trading account of the broker-dealer was exempt from the normal margin rules that control the leverage of other active trading hedge funds and individuals. Sponsors of this high leverage environment argued that broker-dealers provided liquidity to the market and their leverage was checked by capital adequacy rules. In practice, while trading firms might have been obliged to end a trading day at a firm-established level, such as 30x leverage, they might have traded at several multiples of this during the course of the trading day.

The single largest bailout went to AIG which lacked the capital to cover CDS exposure to its counterparties. This stemmed from artful arbitrage of capital and regulatory regimes. Market fears regarding Bear Stearns' health precipitated an abrupt termination of its liquidity, which proved fatal given its extraordinary leverage. Lehman's lack of capital to buttress poor assets led to its bankruptcy.

To address these capital and leverage inadequacies, leading observers have called for significant reforms.

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[155] 12 U.S.C. § 1851(d)(3)

[156] See Jane D'Arista, testimony, House Financial Services, Oct. 29, 2009, available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/d%27arista.pdf

[157] Net capital rules require only that a broker-dealer maintain capital equivalent to 2 percent of customer receivables (money owned by customers or other market participants to the broker-dealer.)

[158] Some observers such as Alan Blinder and Jane D'Arista contend net capital rule changes adopted by the SEC in 2004 ratified the ability of broker-dealers, newly aligned with commercial banks through Gramm-Leach-Bliley, to adopt leverage ratios for trading accounts exceeding $30 for each $1 of capital. http://www.house.gov/apps/list/hearing/financialsvcs_dem/d%27arista.pdf Whether the 2004 SEC change made this possible is contested by certain agency commenters, such as Erik Sirri, then director of the SEC's Division of Trading and Markets. Leverage levels were high in the 1990s as well. But during this period, these firms were not affiliated with FDIC-insured banks. See Sirri speech at: http://www.sec.gov/news/speech/2009/spch040909ers.htm

SEC Chair Mary Schapiro testified before the Financial Crisis Inquiry Commission that "capital adequacy rules were flawed and assumptions regarding liquidity risk proved overly optimistic" in the years leading to the financial crisis.[159] She observed that her agency "may recommend additional regulatory capital charges to address liquidity risk."[160]

Former FDIC Chair Sheila Bair observed that regulators enforcing the Volcker Rule should focus "on the underlying economics of a transaction. If the transaction makes money the old-fashioned way -- the customer paying the institution for a service through interest, fees, and commissions -- then it passes the test. If profitability (or loss) is driven by the direction of markets, then it fails. Inevitable gray areas, such as market-making, need to be done outside of the insured bank and be supported by a truckload of capital."[161]

Former Goldman Sachs CEO Henry Paulson explained, "At Goldman, we had absolutely obsessed over our liquidity position. ,. . We asked how much money, under the most adverse conditions, could disappear on any given day. … To be on the safe side, we kept a lockbox at the Bank of New York filled with bonds that were never invested or lent out. When I was CEO at Goldman, we had amassed $60 billion in these cash reserves alone."[162]

Former president of the Federal Reserve Bank of New York (and current Goldman Sachs managing director) Gerald Corrigan concurred. "In looking to the future, almost everyone who has seriously studied the causes of the crash agrees that certain basic reforms are a must. . . . Higher and more rigorous capital and liquidity standards that recognize the compelling reality that managing and supervising capital adequacy and liquidity adequacy must be viewed as a single discipline."[163]

The Independent Community Bankers Association explained that the banking crisis attested to the failure of allowing large financial institutions to determine their own capital requirements. "The largest financial institutions … need to be subject to a rigorous standard of risk-based capital requirements that are established by the banking agencies." [164]

Former Citigroup CEO John Reed stated, "Capital should be significantly increased, maybe doubled."[165]

In a study sponsored by the Securities Industry and Financial Markets Association, Stanford's Darrell Duffie also argued for stricter "capital and liquidity requirements" as a "more direct and

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[159] http://www.sec.gov/news/testimony/2010/ts011410mls.htm

[160] Shaprio also said the SEC has considered "imposing certain explicit leverage-based requirements, such as requiring broker-dealers to provide "early warning" notice to regulators if their leverage exceeds certain levels." http://www.house.gov/apps/list/hearing/financialsvcs_dem/schapiro_4.20.10.pdf

[161] "**We need a new Volcker rule for banks," by Sheila Bair,** Fortune, Dec. 9, 2011.

[162] "On the Brink," by Henry Paulson, p. 93

[163] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=506fc179-ada7-456b-9b53-fc472b1763ff

[164] These comments are specifically directed to a rulemaking regarding Dodd Frank Section 171(b) on risk-based capital standards, available at: http://www.icba.org/files/ICBASites/PDFs/cl022811a.pdf

[165] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=753820b3-7c27-4ae7-8888-9e7a7ff38453

effective means of handling the legislated exemption for market making." He observed that leading up to the crisis, "The regulatory capital and liquidity requirements of financial institutions were clearly insufficient. These requirements should continue to be strengthened as deemed appropriate by regulators to robustly protect the Deposit Insurance Fund."[166]

MIT Prof. Simon Johnson, former chief economist for the International Monetary Fund, has argued for ambitious capital standards, asserting that figures as high as 30 percent will be required for true prudence. (He has viewed the advances of Basel III as "not encouraging.")[167] Derivative positions deserve special attention, according to Prof. Johnson, and should be converted to a "maximum loss" principle, where the banks should calculate their total exposure as they would for a plain vanilla non-derivative position. The capital should be the same as that held for a non-derivative equivalent.[168]

Increasing capital requirements would not have significant adverse effects on the credit available to the nonfinancial sector or on economic growth and employment, according to scholars Samuel Hanson and colleagues.[169] Brookings Institution scholar Douglas Elliot, who was a former executive with J.P. Morgan, concurred: "The industry has very significantly exaggerated the likely impact of the capital changes."[170]

Responsible capital and leverage requirements also will help the Agencies implement the statute's ban on proprietary trading, which becomes more profitable with higher leverage. Serving legitimate customer interest in buying or selling a financial position in which an institution serves as a market maker should require less leverage. Higher capital requirements will reduce capital arbitrage incentives, wherein a banking entity may be motivated to move an asset from its banking to its trading account to exploit laxer requirements.

While emphasizing the importance of capital and quantitative measures, we remain supportive of the important activity restrictions outlined in the proposed rule. Capital charges can be undermined by a firm's understanding and valuation of the assets it is holding. Many firms with extensive computer modeling expertise have faltered, including not just Long-Term Capital Management but, in the financial crisis, many of the largest financial institutions.[171]

Non-Bank Proprietary Trading

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[166] "Market Making Under the Proposed Volcker Rule," by Darrell Duffie, Stanford University, January 16, 2012
[167] Senate Banking Committee testimony, Dec. 7, 2011.
[168] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=98845464-f06e-4f20-b1bd-cbce9a87803c
[169] http://www.economics.harvard.edu/faculty/stein/files/JEP-macroprudential-July22-2010.pdf
[170] "Studies Question Bank Capital Fears," by David Enrich, Wall Street Journal, August 4, 2010
[171] See, for example, "Computational Complexity and Information Asymmetry in Financial Products," by Arora et al, Princeton University, October, 2009, available at: http://scholar.princeton.edu/markus/files/derivative.pdf

Effective implementation of Section 619 will require major banks to shed proprietary risks that may resurface in non-banking financial institutions. Should this activity be adopted by a wide range of relatively small, well capitalized firms, the proposed rule will have succeeded. Non-banking financial institutions, however, figured at the center of the 2008 crisis, and the taxpayer bailout extended well beyond traditional, federally insured institutions.

The final rules should apply strictly to the shadow banking system. Section 13(a)(2) instructs that non-bank financial companies judged to be systemically significant by the FSOC be subject to additional capital requirements and quantitative limits when engaging in proprietary trading or fund investment. Effective implementation of this provision will be critical to address the issue of risk migration.

Economic Impact

In Part VI of the preamble, the Agencies address and invite comment on the economic impact of the proposed rule. Generally, the Agencies dwell on compliance costs such as administrative expenses, with relatively little attention to the broader issues that led Congress to approve Section 619. The public policy foundation for the statute merits at least some attention. As difficult decisions arise in making specific determinations regarding appropriate activity, whether across an industry or at an individual banking entity, judgment of social benefit will inevitably arise, and the Agencies should be mindful of the general problem that the statute addresses.

Senators Levin and Merkley identified proprietary trading losses of $230 billion in the years associated with the financial crash culminating in the fall of 2008. Eventually, the taxpayer bailout equated to clearly identifiable figures for specific firms. This included $45 billion for Bank of America, much of which was associated with its acquisition of Merrill Lynch, one of the most prominent proprietary traders in failed CDOs. [172] [173] Administrative costs for bankruptcy of Lehman Brothers exceeded $2 billion as of October, 2011. [174]

"Trading on the firm's account has everything to do with the crisis and the misaligned incentives in the financial system," wrote Matthew Richardson, Roy Smith and Ingo Walter of New York University's Stern School of Business "These activities involve risky position taking (such as the substantial, nearly fatal proprietary investments in asset-backed securities made by Citigroup, UBS, Merrill Lynch, Lehman Brothers, and Bear Stearns), and were arguably not necessary for banking operations."[175]

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[172] "The Dodd-Frank Restrictions on Proprietary Trading," by Sen. Jeff Merkley and Sen.Carl Levin, Harvard Law Journal, available at http://www.harvardjol.com/wp-content/uploads/2011/07/Merkley-Levin_Policy-Essay.pdf

[173] Also, Gillian Tett, "Super senior CDO investors flex their muscles," April 14, 2008, Financial Times (available by subscription only)

[174] From speech by Sheila Bair, available at: http://www.c-spanvideo.org/program/FinancialRegulationsLaw

[175] "Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance," by Viral V. Acharya et al, New York: Wiley, 2011, at p. 202.

When proprietary trading positions proved disastrous, panic seized financial markets. Short-term funding failed to function completely. With the economy faltering under failed credit markets, the Federal Reserve expended $8.2 trillion from the beginning of the crisis through December 2009.[176] These costs do not address the devastation to 15 million Americans still without work, the 5 million foreclosures, and the evisceration of retirement savings, alone estimated at $17 trillion between 2007 and 2009 because of the financial crisis.[177]

In response to Question 361, avoiding such future costs clearly constitutes a benefit the Agencies should consider. Social benefits of market making and underwriting, therefore, should be understood in context as Agencies explore the boundary between permitted and prohibited activity.

The statute promises benefits for banking entities. We welcome the Agencies' observation that barring firms from trading in conflict with their customers "should promote investor confidence by helping to ensure that market making serves customer needs."[178] In response to Question 351, we believe that firms may attract new customers who might otherwise be concerned that banks engaged in proprietary trading violate their interests. There is ample reason to believe that a financial marketplace characterized by fair dealing will be more stable, healthy, and economically productive than one characterized by conflicts of interest.

Question 357 solicits comment on broad issues of "liquidity, price efficiency, capital formation, efficiency, and competition." These subjects draw considerable academic attention. Promotion of one of these issues may not benefit another. Numerous studies and commentaries have challenged whether the increase in trading volume, for example, helps capital formation or economic health, as noted earlier in reference to a study by Thomas Philippon.[179] Market liquidity may deliver economic value "up to a point," observed Adair Turner, Chairman of the UK Financial Services Authority, "but not limitlessly." For example, foreign exchange futures carry trades do not serve global trade, he said.[180]

Many proprietary trading desks have already been dismantled with no apparent negative impact on the real economy. For example, Goldman Sachs reportedly disbanded its "principle-strategies" business in September, 2010.[181] Citigroup closed its equity proprietary trading desk in January, 2012.[182]

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[176] Bloomberg, "Taxpayer Pledges Fall to $8.2 Trillion in US Bailout," Bob Ivry, December 23, 2009; see also Bloomberg, "Financial Rescue Nears GDP as Pledges To $12.8 Trillion," Mark Pittman and Bob Ivry, March 31, 2009.

[177] The Hill, "Financial Crisis Cost Households $17 Trillion, Treasury Official Says," Jay Heflin, May 3, 2010.

[178] Federal Register at 68926.

[179] Philippon, Thomas, Has the U.S. Finance Industry Become Less Efficient? (December 2011). NYU Working Paper No. FIN-11-037. Available at SSRN: http://ssrn.com/abstract=1972808

[180] "The Future of Finance," by Adair Turner, available at: http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter11.pdf

[181] "Goldman Sachs Said to Shut Principal Strategies Unit," by Christine Harper, Bloomberg, Sept. 4, 2010, available at: http://www.bloomberg.com/news/2010-09-03/goldman-said-to-shut-principal-strategies-unit-to-comply-with-volcker-rule.html

[182] "Citigroup to Close Prop Trading Desk, by Kevin Roose, Dealbook, January 27, 2012, available at: http://dealbook.nytimes.com/2012/01/27/citigroup-to-close-prop-trading-desk/

In response to Questions 352-4 and Question 360, regarding policy and record keeping burdens, we believe compliance may be simple and self-evident to banking entities. Observed Chairman Volcker, "Every banker I speak with knows very well what "proprietary trading" means and implies. My understanding is that only a handful of large commercial banks – maybe four or five in the United States and perhaps a couple of dozen worldwide – are now engaged in this activity in volume. In the past, they have sometimes explicitly labeled a trading affiliate or division as "proprietary," with the connotation that the activity is, or should be, insulated from customer relations."[183]

Ready information exists at firms that can identify for the Agencies proprietary trading within ostensible market-making operations. Financial institutions already collect and precisely analyze detailed information related to their business. This includes information on trading, which is analyzed on a daily, weekly and quarterly basis. Goldman Sachs CFO David Viniar noted, "I personally see the profit and loss statement of each of our 44 business units every single night."[184] Such data applies especially where the firm's own capital is at risk. An institution that claims not to gather such material would be in violation of its own audit standards.[185] Indeed, a survey by the Ernst & Young of broker dealers about leading issues in Dodd-Frank compliance found that the Volcker Rule ranked lowest in terms of "impact."[186]

In response to Question 362, regarding the benefits of restrictions on derivatives, we note numerous studies questioning the value of the rising complexity of financial instruments. For example, Chairman Turner of the UK Financial Services Authority noted that "until the recent crisis, this growing scale and complexity were believed to enhance both efficiency and stability. That assumption was wrong."[187]

Generally, prudential management should promote long term shareholder value. Responding to one congressional critic, MIT Prof Simon Johnson noted: "Congressman Bachus argues that implementing the Volcker Rule will hurt the shareholders of major banks. This is far from clear – shareholders lost heavily when banks' gambles went so dramatically wrong in 2007-08. But even if it were the case, this would be irrelevant. The goal of your rule making is surely not to help a particular set of shareholders, but rather to strengthen financial stability and increase the likelihood that we will not fact another devastating financial crisis."[188]

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[183] http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4

[184] "Trading eludes Dodd-Frank," http://www.bloomberg.com/news/2010-09-12/trading-eludes-dodd-frank-as-no-investors-see-inside-black-box.html

[185] Gathering and review of this data in a robust and nimble electronic system is already required by numerous rules, regulations and statutes as well as by compliance and outside auditors (not to mention the Audit Committee). In particular, the outside auditors must annually determine whether the company has an effective and comprehensive system of internal controls.

[186] Available at http://blogs.law.harvard.edu/corpgov/2011/10/08/broker-dealers-respond-to-dodd-frank-and-finra/

[187] "What do Banks Do," by Adair Turner, available at http://harr123et.files.wordpress.com/2010/07/futureoffinance-chapter11.pdf

[188] http://baselinescenario.com/2010/11/07/making-the-volcker-rule-work/